Investment Management Regulatory Update

December 30, 2020

COVID-19 Update

Rules and Regulations

- SEC Modernizes Framework for Registered Fund Valuation Practices
- SEC Adopts Modernized Marketing Rule for Investment Advisers

Industry Update

- OCIE Issues Risk Alert on Observations from Examinations of Investment Adviser Compliance Programs
- Staff Statement on Wyoming Division of Banking's "NAL on Custody of Digital Assets and Qualified Custodian Status"

Litigation

- Five Advisory Firms and Broker-Dealers Settle SEC Charges Relating to Improper Sales of Exchange-Traded Products
- SEC Settles with Investment Advisers for Alleged Disclosure Failures Relating to Transfer of "Top Traders" to Proprietary Hedge Fund

COVID-19 Update

Please refer to Davis Polk's "**Coronavirus Updates**" webpage for content related to the outbreak.

Rules and Regulations

SEC Modernizes Framework for Registered Fund Valuation Practices

Summary

In a December 3, 2020 **release** (the "**Release**"),[1] the Securities and Exchange Commission (the "**SEC**") adopted Rule 2a-5 (the "**Rule**") and companion Rule 31a-4 (the "**Companion Rule**") under the Investment Company Act of 1940, as amended (the "**Investment Company Act**"). The Rule establishes a framework for good-faith determinations of the fair value of a registered fund's investments under Section 2(a)(41) of the Investment Company Act and Rule 2a-4 thereunder. The Companion Rule requires an adviser to maintain certain records in support of its fair value determinations and periodic reports to the fund's board.

Under the Rule, good faith determinations of fair value require certain functions to be performed, such as:

[1] *Good Faith Determinations of Fair Value*, SEC Release No. IC-34128 (December 3, 2020).

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- assessing and managing material risks associated with fair value determinations, including material conflicts of interest;
- selecting, applying and testing fair value methodologies; and
- overseeing and evaluating any pricing services used.

According to the Release, the Rule is designed to address market developments in registered fund valuation practices, including the greater variety of asset classes held by registered funds, enhanced availability and volume of data used in valuation determinations, and increased use of third-party pricing services. The Release also recognizes the important role and expertise provided by registered fund advisers in the valuation process. Notably, the Rule expressly permits a fund board to designate a valuation designee to perform the valuation functions required under the Rule, which must be the fund's investment adviser (or an officer of the fund if it does not have an investment adviser), subject to additional recordkeeping, reporting and other requirements designed to facilitate the board's oversight of such designee's fair value determinations. The Rule also defines when a market quotation would be considered "readily available" for purposes of Section 2(a)(41) and provides that for a registered fund that is a unit investment trust, the required valuation functions under the Rule must be performed by the fund's trustee or depositor, if the initial deposit of portfolio securities into the unit investment trust occurs after the Rule's effective date.

Key Takeaways

Some key takeaways of the Rule include:

- Registered fund boards are expressly permitted to designate a valuation designee to perform fair value determinations, where "valuation designee" is defined to mean the investment adviser (other than a sub-adviser) or officer of the fund (if there is no investment adviser). This is a change from the April 21, 2020 proposing release (the "**Proposing Release**"), which would have permitted the assignment of a fund's fair value determinations to the fund's investment adviser, including a sub-adviser.
- Requirements regarding segregation of an adviser's portfolio management from its valuation function, and additional reporting to fund boards, will increase regulatory compliance obligations for advisers, which may be burdensome for smaller investment advisers.
- Registered funds will likely need to review and revise their Rule 38a-1 policies to reflect new requirements under the Rule.

Background

In the Release and Proposing Release, the SEC emphasized that proper valuation of a registered fund's investments is critically important because it affects the accuracy of the fund's NAV calculation and supports the purchase and sale of the fund's shares at fair prices. Proper valuation of a registered fund's investments also promotes accuracy in the fund's fee calculations, disclosures to investors regarding performance and fees, and compliance with investment policies and limits required under the Investment Company Act. For these reasons, federal securities laws impose liability on registered funds, fund boards and advisers for improper valuations of fund investments and material misstatements regarding a fund's valuation process. The SEC noted that it last issued guidance regarding valuation in 1970,[2] and that

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[2] Accounting Series Release 113, SEC Release No. IC-5847 (Oct. 21, 1969) ("ASR 113"); Accounting Series Release 118, SEC Release No. IC-6295 (Dec. 23, 1970) ("**ASR 118**"). With the adoption of Rule 2a-5, the SEC will rescind ASR 113, ASR 118 and certain other SEC staff letters relating to valuation that would be superseded or inconsistent with the rule.

certain market and regulatory developments[3] since then have significantly altered how registered funds, fund boards, advisers and other fund service providers perform fair value determinations. For example, the SEC noted that the increased complexity of fund portfolios and data used for valuations have led many fund boards to seek clarity on how they can "effectively fulfill their fair value determination obligations while seeking the assistance of others."[4] In light of these developments, the SEC believes the Rule will provide a consistent framework, as further described below, for valuation practices across registered funds, and to allow fund boards to designate a valuation designee to make fair value determinations with effective board oversight.

Rule Requirements

Determination of Fair Value

Under the Rule, a good faith determination of fair value for purposes of Section 2(a)(41) of the Investment Company Act and Rule 2a-4 thereunder would require performance of the following functions:

Assess and Manage Risks: The Rule requires periodic assessment of valuation risks, including material conflicts of interest. Other than conflicts of interest, the proposed rule does not prescribe the specific risks that must be addressed to satisfy the rule because, as reiterated in the Release, the SEC believes that the valuation risks for each particular fund would depend on the facts and circumstances of such fund's investments. The Release includes a non-exhaustive list of the sources and types of valuation risk a fund could face, including:

- the types of investments held or intended to be held by the fund and the characteristics of such investments;
- potential market or sector shocks or dislocations (e.g., significant changes in short-term volatility, market liquidity, trading volumes or sudden increase in trading suspensions) or other types of disruptions that may affect a valuation designee's or third party's ability to operate;
- the extent to which a fund's fair value methodology uses unobservable inputs, particularly if provided by the valuation designee;
- the proportion of a fund's investments that are fair valued in good faith, and their contribution to the fund's returns;
- use of third-party service providers, e.g., service providers with limited expertise in relevant asset classes; use of fair value methodologies that rely on inputs from third-party service providers; use of third-party service providers that rely on their own service providers; and
- inappropriate fair value methodologies, or inconsistent or incorrect application of such methodologies.

Consistent with the Proposing Release, the Rule does not prescribe a required frequency for the periodic assessments of valuation risks. In the Release, the SEC restated its belief that different frequencies may be appropriate for different funds depending on the fund's valuation risks, and that the periodic

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[3] For example, the establishment of the Public Company Accounting Oversight Board under the Sarbanes-Oxley Act of 2002, the adoption of compliance Rule 38a-1 under the Investment Company Act and Rule 206(4)-07 under the Investment Advisers Act of 1940, and issuance of FASB guidance on fair value under US GAAP.

[4] Proposing Release at 4.

assessments should take into account factors such as changes in fund investments, significant changes in fund investment strategies or policies, and market events.[5]

Establish and apply fair value methodologies: The Rule requires selecting, and consistently applying, appropriate fair valuation methodologies, which would include specifying the key inputs and assumptions for each asset class or portfolio holding.[6] In a change from the Proposing Release, the Rule omits a requirement under which the board or valuation designee would have to consider the applicability of the selected fair value methodologies to types of investments a fund does not currently own but in which such fund intends to invest. The Rule was also modified from the proposed version to provide flexibility for selected methodologies to be changed if different methodologies are equally or more representative of the fair value of investments. The Rule also requires periodic review of the appropriateness and accuracy of the selected methodologies and adjustment, if needed. The Release does not specify a particular valuation methodology to be used (recognizing that the methodology would depend on the facts and circumstances of each investment, the relevant market and market participants), but clarifies that to be appropriate under the proposed rule, the methodology used must be consistent with the valuation approaches set forth in FASB ASC Topic 820. The Rule also requires the board or valuation designee, as applicable, to monitor for circumstances that may require fair valuation,[7] but in a change from the proposed rule, does not require the board or valuation designee to establish criteria for determining when market quotations are no longer reliable and readily available.

Test fair value methodologies: The Rule requires testing of the appropriateness and accuracy of the fair value methodologies selected, including identifying the testing methods to be used and the frequency of testing.

- *Evaluate pricing services*: The Rule requires oversight of pricing services used, which would include establishing a process for approving, monitoring and evaluating each pricing service provider and for initiating pricing challenges. The Release stated that such evaluation should take into account factors such as:
  - qualification, experience and history of the pricing service;
  - valuation methods or techniques, inputs or assumptions (e.g., whether inputs or assumptions are provided by the fund's adviser) used by the pricing service for different classes of holdings and how they are affected by changing market conditions;
  - quality of pricing information provided by the service and the extent to which the service determines its pricing information as close as possible to the time as of which the fund calculates net asset value;
  - process for considering pricing challenges, including how information received from such challenges are incorporated into the pricing service's pricing information;

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[5] Release at 14.

[6] As an example, consistent with the Proposing Release, the SEC noted in the Release that it would not be sufficient under the Rule "to simply state that private equity investments are valued using a discounted cash flow model, or that options are valued using a Black-Scholes model, without providing any additional detail on the specific qualitative and quantitative factors to be considered, the sources of the methodology's inputs and assumptions, and a description of how the calculation is to be performed (which may, but need not necessarily, take the form of a formula)." Release at note 51.

[7] As an example, the Release states that "if a fund invests in securities that trade in foreign markets, the board or adviser generally should identify and monitor for the kinds of significant events that, if they occurred after the market closes in the relevant jurisdiction but before the fund prices its shares, would materially affect the value of the security and therefore may suggest that market quotations are not reliable." Release at 25.

- potential conflicts of interest of the pricing service, and how the pricing service mitigates such conflicts; and
- testing processes used by the pricing service.

Fair value policies and procedures: In a change from the Proposing Release, the SEC omitted the requirement related to the adoption and implementation of written policies and procedures designed to achieve compliance with the Rule, acknowledging that existing requirements of Rule 38-1 made this requirement duplicative.[8]

Recordkeeping: The SEC also simultaneously adopted the Companion Rule imposing a requirement to maintain "appropriate" documentation related to the new Rule, rather than delineating those requirements in the Rule itself as was done in the Proposing Release. The Release stated that the creation of a separate recordkeeping rule would ensure that a failure to maintain appropriate records would not by itself lead to a board being found to have not acted in good faith.[9] The Companion Rule requires a registered fund to maintain supporting documentation for fair value determinations for six years (a change from five years in the Proposing Release), with the first two years in an easily accessible place. However, given that the SEC did not adopt the proposed requirement to establish fair value policies and procedures in light of the existing requirements of Rule 38-1 (as noted above), the Companion Rule does not contain a requirement to maintain copies of such policies and procedures as was the case in the Proposing Release. In another departure 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 a pricing service.

Performance of and Designation of Valuation Designee for Fair Value Determinations

Under the Rule, a registered fund's board may choose to perform the required fair valuation functions itself, or designate a valuation designee to carry out such functions (subject to board oversight), which must be the fund's investment adviser (or an officer of the fund if it does not have an investment adviser). In a change from the Proposing Release, the definition of valuation designee expressly excludes a fund's sub-advisers. In the Release, the SEC reiterated that the board's oversight of the valuation designee's conduct related to the valuation function should not be a passive activity,[10] and that a fund board should use a level of scrutiny appropriate for the fund's valuation risks, including the extent to which valuations depend on subjective inputs and assumptions. In particular, the SEC reemphasized that the board should serve as "a meaningful check on the conflicts of interest of the valuation designee and other service providers involved in the determination of fair values" who may have an incentive to improperly value a fund's investments to increase fees, improve or smooth reported returns, comply with fund investment policies or restrictions, or maintain favorable business relationships with the adviser.[11]

Reports to the Board

To help ensure that a fund board receives the amount and type of information needed to carry out its oversight responsibilities, the Rule requires a valuation designee to provide the following reports to the board:

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[8] Release at 37.

[9] Release at 82.

[10] For example, the Release notes that fund boards should "probe the appropriateness of the valuation designee's fair value process" and 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." Release at 58.

[11] Release at 57.

- at least quarterly,
  - any reports or materials requested by the board related to the fair value of designated investments or the valuation designee's process for making fair value determinations;
  - a summary or description of material fair value matters that occurred in the prior quarter, including:
    - any material changes in the assessment and management of valuation risks required under the Rule, including material changes in conflicts of interest of the valuation designee (and any other service provider);
    - any material changes to, or material deviations from, the fair value methodologies established under the Rule; and
    - any material changes to the valuation designee's process for selecting and overseeing pricing services, and material events related to the valuation designee's oversight of pricing services (e.g., changes in service providers or price overrides).
- Annual written assessments of the adequacy and effectiveness of the valuation designee's fair value process for the designated portfolio, which must include at a minimum:
  - a summary of the results of the testing of such fair value methodologies, as required under the Rule; and
  - an assessment of the adequacy of resources allocated to the fair valuation process of designated investments, including material changes to the roles or functions of persons responsible for determining fair value under the Rule.

  This is a change from the Proposing Release, as the items noted for inclusion in the annual report were initially to be included in the quarterly reports. The Rule also clarifies that the annual assessment may contain a summary of testing results and omits a requirement to report service provider changes or price overrides as per se material events related to the oversight of pricing sources.
- Prompt reporting of matters (no later than five business days after the valuation designee becomes aware of the matter) that materially affect the fair value of the designated portfolio, including a significant deficiency or material weakness in the design or implementation of the valuation designee's process or material errors in the calculation of net asset value. This represents a change from the Proposing Release, which would have required notification within three business days, and comports with the SEC's acknowledgment that the materiality of some matters may not be immediately apparent. In another departure from the Proposing Release, the Rule removes the notification requirement regarding the occurrence of a matter that "could have materially affected" the fair value.

Specified Responsibilities and Segregation of Portfolio Management

The Rule requires the valuation designee to specify the titles of persons responsible for making fair value determinations of the designated portfolio, including the functions for which they are responsible. In order to comply with this requirement, the Release notes that the valuation designee's policies and procedures should identify persons responsible for handling price challenges and authorized to override prices, and their roles and responsibilities.[12]

[12] Release at 75-76.

The Rule also requires a valuation designee to reasonably segregate its fair value process from portfolio management of the fund. The Release emphasizes that because portfolio managers are often compensated based on a fund's returns, they may have incentives that conflict with the fund's interests. Therefore, reasonable segregation is needed to promote effectiveness of the fair value process. However, the SEC also recognized that the portfolio managers for a fund may have the most knowledge of a fund's portfolio to be able to provide useful input and insight in the fair value process. The Release clarifies that Rule is not intended to prevent portfolio managers from being able to provide such input and insight, or to require that portfolio managers be subject to a strict communications firewall. Instead of taking a prescriptive approach, the Rule allows reasonable segregation to be "tailored to each fund's facts and circumstances, including the size and resources of a particular fund" and may use a variety of methods, such as independent reporting chains, oversight arrangements, or separate monitoring systems and personnel.[13] However, in a change from the proposed rule, the final Rule clarifies that in order to satisfy the reasonable segregation requirement, "the portfolio manager(s) may not determine, or effectively determine by exerting substantial influence on, the fair values ascribed to portfolio investments."

Records of Designation

To facilitate the board's oversight of a valuation designee's fair value determinations, the Companion Rule requires a fund (or its adviser, if the adviser is the valuation designee) to maintain copies of reports and other information provided to the board as required under the Rule, and lists of investments or investment types whose fair value determinations have been designated to the valuation designee. The records are required to be kept for six years, with the first two years in an accessible place.

Readily Available Market Quotations; Unit Investment Trusts

Under the Rule, a market quotation will be considered "readily available" for purposes of Section 2(a)(41) only when the "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 SEC acknowledged commenters' concerns that the new definition of readily available market quotations may disrupt current cross-trading practices under Rule 17a-7. However, the SEC confirmed in the Release that the new definition will apply in all contexts under the Investment Company Act, including Rule 17a-7, where the SEC believes it serves to ensure an independent basis for determining the value of securities. In the Release, the SEC stated its belief that to be appropriate under the Rule, a fair value methodology must be determined solely by reference to level 1 inputs under US GAAP. Therefore, a quote would be considered unreliable under the Rule if US GAAP would require adjustments or consideration of additional inputs to determine fair value. The Release also clarified that evaluated prices, indications of interest, and accommodation quotes would not be considered "readily available" market quotations under the Rule.

If the registered fund is a unit investment trust, the Rule requires the fund's trustee or depositor to perform the valuation functions described above because a unit investment trust does not have a board of directors or an adviser. If the initial deposit occurs prior to the Rule's effective date and an entity other than the fund's trustee or depositor has been tasked with carrying out fair value determinations, that entity must carry out those requirements.

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[13] Release at 79.

Transition Period

The SEC adopted an eighteen-month transition period from the effective date of the rules (an increase from the one year transition period contemplated by the Proposing Release) to provide time for registered funds and their investment advisers to prepare for compliance with the final rule.

SEC Adopts Modernized Marketing Rule for Investment Advisers

In a December 22, 2020 release (the "**Release**"), the SEC adopted amendments (the "**Amendments**") to create a single rule that will replace the current advertising and cash solicitation rules under the Investment Advisers Act of 1940, as amended (the "**Advisers Act**"). The Amendments relate primarily to Rule 206(4)-1 (the "**advertising rule**") and Rule 206(4)-3 (the "**solicitation rule**"), which have remained largely unchanged since their adoptions decades ago and will now be merged into a single marketing rule under Rule 206(4)-1, as amended. The Amendments have important implications for all investment advisers, including private equity and other private fund managers, particularly with respect to presentation of performance and solicitation activities. Davis Polk has issued a client alert and is preparing a client memorandum which will include a more detailed discussion of the Amendments.

Industry Update

OCIE Issues Risk Alert on Observations from Examinations of Investment Adviser Compliance Programs

On November 19, 2020, the SEC's Office of Compliance Inspections and Examinations ("**OCIE**") issued a risk alert to share observations from its examinations of investment adviser compliance programs. The risk alert provided an overview of compliance issues identified by OCIE related to Rule 206(4)-7 (the "**compliance rule**") under the Advisers Act. Under the compliance rule, registered investment advisers are required to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules promulgated thereunder by the investment adviser and its supervised persons. The compliance rule requires that investment advisers consider their fiduciary and regulatory obligations under the Advisers Act and that they formalize policies and procedures to address such obligations.

The compliance rule does not prescribe specific elements that investment advisers must include in their policies and procedures, and each investment adviser should adopt policies and procedures that take into consideration the nature of such investment adviser's operations. The OCIE noted that investment advisers should design policies and procedures to prevent violations from occurring and detect and remedy violations that have already occurred.

The compliance rule also requires that each investment adviser review its policies and procedures at least annually to determine their adequacy and the effectiveness of their implementation. According to the risk alert, the annual review should consider "any compliance matters that arose during the previous year, any changes in the business activities of the adviser or its affiliates, and any changes in the Advisers Act or applicable regulations that might suggest a need to revise the policies or procedures." Although the compliance rule requires only annual reviews, investment advisers should consider the need for more frequent reviews, particularly in response to significant compliance events, changes in business arrangements and regulatory developments.

The compliance rule also requires each investment adviser to designate a chief compliance officer ("**CCO**") to administer its compliance policies and procedures. The OCIE noted that an investment adviser's CCO, in addition to being competent and knowledgeable regarding the Advisers Act, should be

empowered with the authority to develop and enforce policies and procedures for the investment adviser in light of its business.

The OCIE staff highlighted the deficiencies outlined below in its risk alert.

Inadequate Compliance Resources

One deficiency observed by the OCIE staff was a lack of adequate resources being devoted to investment adviser compliance programs. The risk alert highlighted the following examples:

- Some CCOs had numerous other professional responsibilities, either elsewhere within the investment adviser or with outside firms, and did not appear to devote sufficient time to fulfilling their responsibilities as CCO. While CCOs may have responsibilities in addition to their CCO role, OCIE observed cases "where such CCOs did not appear to have time to develop their knowledge of the Advisers Act or fulfill their responsibilities as CCO."
- Compliance staff at investment advisers who did not have sufficient resources in order to implement an effective compliance program. OCIE staff observed investment advisers that did not appear to devote sufficient resources to their compliance functions; for example, certain investment advisers did not provide adequate training or had insufficient staff. This lack of resources affected the implementation of the compliance policies and procedures adopted by certain investment advisers (or compliance with regulatory requirements), such as performance of annual reviews, accurate completion and filing of Form ADVs or timely responses to OCIE requests for required books and records.
- In cases where investment advisers had experienced growth in size or complexity but had not hired additional compliance staff or added adequate information technology, there were resulting failures in the implementation or tailoring of compliance policies and procedures.

Insufficient Authority of CCOs

The OCIE staff also observed CCOs "who lacked sufficient authority within the adviser to develop and enforce appropriate policies and procedures for the adviser." The risk alert highlighted the following examples:

- Some CCOs were restricted from accessing critical compliance information (e.g., trading exception reports and investment advisory agreements with key clients).
- For some investment advisers, senior management appeared to have limited interaction with their CCOs, "which led to CCOs having limited knowledge about the [investment adviser]'s leadership, strategy, transactions and business operations."
- Some CCOs were not consulted by senior management or employees of the investment adviser regarding matters with potential compliance implications.

Annual Review Deficiencies

The OCIE observed investment advisers that were "unable to demonstrate that they had performed an annual review or whose annual reviews failed to identify significant existing compliance or regulatory problems." The risk alert highlighted the following examples:

- *Evidence of annual review*. Certain investment advisers claimed to engage in ongoing or annual compliance reviews of their policies and procedures to determine the adequacy of such policies and procedures (as well as the effectiveness of their implementation), but could not provide evidence that such a review occurred.

- *Identification of risks*. Certain investment advisers claimed to have performed limited annual reviews but had failed to identify or review key risk areas applicable to the investment adviser, such as conflicts of interest and protection of client assets.
- *Review of significant aspects of adviser's business*. Certain investment advisers failed to review significant areas of their business, such as policies and procedures surrounding the oversight and review of recommended third-party managers, cybersecurity and the calculation of fees and allocation of expenses.

Implementing Actions Required by Written Policies and Procedures

The OCIE also observed investment advisers that did not implement or perform actions required by their written policies and procedures. The risk alert noted that certain investment advisers failed to:

- train their employees;
- implement compliance procedures regarding trade errors, advertising, best execution, conflicts of interest, disclosure and other requirements;
- review advertising materials;
- follow compliance checklists and other processes, including back-testing fee calculations and testing business continuity plans; and/or
- review client accounts (e.g., in order to determine consistency of portfolios with a client's objectives)

Maintaining Accurate and Complete Information in Policies and Procedures

OCIE observed investment advisers' policies and procedures that contained outdated or inaccurate information about the investment adviser, including generic policies that contained unrelated or incomplete information.

Maintaining or Establishing Reasonably Designed Written Policies and Procedures

The OCIE observed investment advisers that did not maintain written policies and procedures or that otherwise failed to establish, implement or appropriately tailor written policies and procedures reasonably designed to prevent Advisers Act violations. For example, the OCIE observed investment advisers that claimed to rely on informal processes rather than maintaining written policies and procedures as required. In addition, the OCIE observed investment advisers that utilized policies of an affiliate—such as a broker-dealer—which were not tailored to the specific business of the investment adviser.

According to the risk alert, in cases where firms did maintain written policies and procedures, OCIE staff observed deficiencies or weaknesses in the following areas:

- *Portfolio management*
  - Due diligence and oversight of outside managers
  - Monitoring compliance with client investment and tax planning strategies
  - Oversight of third-party service providers
  - Due diligence and oversight of investments, including alternative assets
  - Oversight of branch offices and investment advisory representatives to ensure they were in compliance with the adviser's policies and procedures
  - Compliance with regulatory and client investment restrictions
  - Adherence with investment advisory agreements

- *Marketing*
  - Oversight of solicitation arrangements;
  - Prevention of the use of misleading marketing presentations, including on websites; and
  - Oversight of the use and accuracy of performance advertising
- *Trading Practices*
  - Allocation of soft dollars
  - Best execution
  - Trade errors
  - Restricted securities
- *Disclosures*
  - Accuracy of Form ADV
  - Accuracy of client communications
- *Advisory fees and valuation*
  - Fee billing processes, including how fees are calculated, tested or monitored for accuracy
  - Expense reimbursement policies and procedures
  - Valuation of advisory client assets
- *Safeguards for client privacy*
  - Regulation S-P
  - Regulation S-ID
  - Physical security of client information
  - Electronic security of client information, including encryption policies
  - General cybersecurity, including access rights and controls, data loss prevention, penetration testing and/or vulnerability scans, vendor management, employee training or incident response plans
- *Required books and records*: Deficiencies related to written policies and procedures to make and keep accurate books and records as required under Rule 204-2 under the Advisers Act
- *Safeguarding of client assets*: Deficiencies related to policies and procedures regarding custody and safety of client assets
- *Business continuity plans*: Deficiencies regarding the maintenance of adequate disaster recovery plans (e.g., because the business continuity plans were not tested or did not contain contact information or designate responsibility for business continuity plan actions)

Conclusion

In the risk alert, the OCIE encouraged firms to review their written policies and procedures—including implementation of such policies and procedures—to ensure that they are tailored to an investment adviser's business and adequately reviewed and implemented.

- **See a copy of the Risk Alert**

Staff Statement on Wyoming Division of Banking's "NAL on Custody of Digital Assets and Qualified Custodian Status"

On November 9, 2020, the staff of the SEC Division of Investment Management issued a statement regarding a recent letter by the Wyoming Division of Banking which included views relating to the definitions of "bank" and "qualified custodian" under the Advisers Act and Rule 206(4)-2 thereunder (the "**Custody Rule**").

The Letter

In the letter, the Wyoming Division of Banking sought to address questions surrounding the custody of digital assets and ultimately concluded that the requesting Wyoming-chartered public trust company (the "**Trust Company**") was permitted to provide custodial services for digital and traditional assets under Wyoming law. The Wyoming Division of Banking also concluded that the Trust Company served as a "qualified custodian" under the Custody Rule, and stated that it would not recommend enforcement action to the SEC under these circumstances.

The Wyoming Division of Banking's letter expressly stated that its views "should not be construed to represent the views of the SEC or any other regulatory agency." The SEC staff issued its Statement to encourage parties to connect directly with SEC staff regarding the application of the Custody Rule to digital assets, including with respect to the definition of "qualified custodian." The SEC staff noted that the determination of who qualifies as a "qualified custodian" is complicated, as it is heavily based on specific facts and circumstances.

Request for Feedback

In the Statement, the SEC staff requested feedback on the following topics relating to "qualified custodians":

- "Do state chartered trust companies possess characteristics similar to those of the types of financial institutions the Commission identified as qualified custodians? If yes, to what extent?
- In what ways are custodial services that are provided by state chartered trust companies equivalent to those provided by banks, broker-dealers, and futures commission merchants? In what ways do they differ? Would there be any gaps in - or enhancements to - protection of advisory client assets as a result of a state chartered trust company serving as qualified custodian of digital assets or other types of client assets?
- How do advisers assess whether an entity offering custodial services satisfies the definition of qualified custodian in the Custody Rule? What qualities does an adviser seek when entrusting a client's assets to a particular custodian? Do the qualities vary by asset class? That is, are there qualities that would be important for safeguarding digital assets that might not be important for safeguarding other types of assets? If so, what qualities and why? Should the rule prescribe different qualities based on asset class, or should the rule take a more principles-based approach and allow advisers to exercise care in selecting a custodian?
- Are there entities that currently satisfy the definition of qualified custodian under the Custody Rule that should not be included within that definition because they do not meet the policy goals of the rule? If so, which ones and why? Conversely, are there entities that currently do not satisfy the definition of qualified custodian but should? If so, which ones and why?"

The Statement noted that submissions will be made public and requested that submissions be emailed to: **IMOCC@sec.gov**, with "*Custody Rule and Digital Assets*" included in the subject line.

- **See a copy of the statement**

Litigation

Five Advisory Firms and Broker-Dealers Settle SEC Charges Relating to Improper Sales of Exchange-Traded Products

On November 13, 2020, the SEC announced that it had settled actions against three investment advisory firms and two dually registered broker-dealer and advisory firms related to allegedly improper sales of volatility-linked exchange-traded products. The actions were filed against American Portfolios Financial Services/American Portfolios Advisors Inc. ("**American Portfolios**"), Benjamin F. Edwards & Company Inc. ("**Benjamin Edwards**"), Royal Alliance Associates Inc. ("**Royal Alliance**"), Securities America Advisors Inc. ("**Securities America**"), and Summit Financial Group Inc. ("**Summit Financial**") for their involvement in sales of products that attempted to track short-term volatility expectations in the market.

According to the SEC, representatives of the five firms recommended that clients buy and hold certain volatility-linked exchange-traded notes that offered exposure to futures contracts on the CBOE volatility index (the "**VIX**"). The advisers allegedly made this recommendation even though the offering documents for those products made it clear that they were intended for short-term holding and were likely to experience a decline in value when held over a longer period. The prospectuses for the exchange-traded notes warned that the value of the futures contracts would likely decrease over a long-term period and that the potential upside of investment in the exchange-traded notes would be correspondingly limited. Nevertheless, representatives of the firms recommended that their customers and clients buy and hold the products for longer periods—including, in some circumstances—for months and years.

The SEC further found that each firm failed to adopt written policies and procedures reasonably designed to prevent violations of the Advisers Act and its rules regarding the suitability of recommending investments in volatility-linked exchange-traded products for retail advisory clients. Additionally, the SEC Orders against American Portfolios and Benjamin Edwards found that those firms failed to reasonably supervise certain brokerage representatives who recommended that their customers buy and hold volatility-linked products in violation of federal securities laws.

As set out in all five Orders, the firms violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder. Additionally, as set out in the two Orders for American Portfolios and Benjamin Edwards, the SEC found that the firms violated Section 15(b)(4)(E) of the Securities Exchange Act of 1934 for failing to reasonably supervise their respective registered representatives in an effort to prevent violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act of 1933.

To settle charges, each firm agreed to pay civil money penalties. American Portfolios and Benjamin Edwards will pay $650,000 each, Securities American and Summit Financial will pay $600,000 each, and Royal Alliance will pay $500,000. Additionally, each firm agreed to (i) a censure, (ii) pay disgorgement and prejudgment interest, and (iii) cease and desist from future violations.

- **See a copy of the Press Release**
- **See a copy of the SEC Order – American Portfolios Financial Services and American Portfolio Advisors, Inc.**
- **See a copy of the SEC Order – Benjamin F. Edwards & Company**
- **See a copy of the SEC Order – Summit Financial Group**
- **See a copy of the SEC Order – Securities America Advisors**
- **See a copy of the SEC Order – Royal Alliance Associates**

SEC Settles with Investment Advisers for Alleged Disclosure Failures Relating to Transfer of "Top Traders" to Proprietary Hedge Fund

On December 8, 2020, the SEC issued an order (the "**BlueCrest Order**") instituting and settling cease-and-desist proceedings against BlueCrest Capital Management Limited ("**BlueCrest**"), a previously registered investment advisor, for BlueCrest's allegedly inadequate disclosures, misstatements, and omissions relating to the transfer of "top traders" from management of a client fund, BlueCrest Capital International ("**BCI**"), to a proprietary fund, BSMA Limited ("**BSMA**"). The $170 million of disgorgement and penalties imposed on BlueCrest underscores the SEC's continued focus on alleged investor injury flowing from conflicts of interest between a fund and its managers, and on the adequate, accurate, and advance disclosure of actual or potential conflicts of interest.

According to the Order, from October 2011 through December 2015 (the "**Relevant Period**"), BlueCrest managed a "flagship" client fund, BCI, and a proprietary fund, BSMA. BSMA was 93 percent owned by members of the Executive Committee of BlueCrest. BCI's investors, according to the SEC, included pension funds for American retirees. BlueCrest's primary capital allocations were to rates and relative value ("**Rates and RV**") trading strategies.

The SEC alleges that in 2011, BlueCrest decided to form a proprietary fund to "assist in attracting and retaining the employment of traders and other senior managers." Over the relevant period, BlueCrest allegedly transferred almost half (around 48 percent) of its highest-performing Rates and RV traders—who had been trading for BCI—to BSMA, hired new traders who were eligible to trade for either fund to trade solely for BSMA, and according to communications during this period, "failed adequately to consider the effects on BCI of their allocation of high-performing traders to BSMA, and focused instead on the positive benefits to BSMA."

The BlueCrest order also notes that BlueCrest replaced the capital allocations of the traders transferred to BSMA by allocating a substantial amount of BCI capital to a new semi-systematic, algorithmic trading system—Rates Management Trading ("**RMT**")—which was used to "track[] some of the trading activity of a subset of BlueCrest's live Rates and RV traders but generally underperformed those traders." According to the Order, from 2012 through 2015, BCI's capital allocations to RMT ranged from approximately $1.87 billion to $7.89 billion, which represented 17 percent to 52 percent of BCI's total allocated capital. Without RMT, the SEC found it unlikely that BlueCrest would have been able to move as many traders in such a short time period while maintaining BCI's overall level of allocated capital. The SEC alleges that RMT also created a conflict of interest because BlueCrest could retain a greater percentage of performance fees generated by RMT than they could with performance fees generated by Rates and RV traders. In addition, throughout this relevant time period, BlueCrest continued to increase the capital allocation to RMT in BCI, despite internal reports reflecting that RMT generally performed worse than BlueCrest's live Rates and RV traders.

The SEC alleges that BlueCrest faced a "conflict of interest in managing a proprietary fund, BSMA, whose primary trading strategies overlapped with those of BCI," and that the conflict of interest was exacerbated by the fact that the Executive Committee of BlueCrest had a larger ownership interest in BSMA than in BCI.

According to the SEC, BlueCrest failed adequately to disclose, and made misstatements and omissions to BCI investors and/or prospective investors concerning BSMA's existence, the movement of traders, RMT, and related conflicts of interest. According to the Order, investors would regularly request information on all of BlueCrest's funds—including all of its proprietary funds, BCI's traders, and BlueCrest's conflicts of interest—but while BlueCrest disclosed the existence of other proprietary funds and touted its live traders in BCI, it never mentioned BSMA's existence, trader movements, RMT, and related specific conflicts of interest, to prospective and existing investors. Moreover, BCI's independent directors, who also sat on the BSMA board, received inadequate disclosure concerning certain material facts about RMT as well. For example, in July 2012, BlueCrest told BCI's independent directors that RMT was a "project" that was

"in the early stages of development," when in fact, BlueCrest had been using RMT in BCI since January 2012. Similarly, according to the Order, BlueCrest failed to inform independent directors about its conflict of interest in deploying RMT, or the fact that RMT underperformed the live traders whom it tracked.

Based on the conduct described above, the SEC alleged that BlueCrest 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)-7 and 206(4)-8 thereunder. The SEC ordered BlueCrest to cease and desist from any further violations and ordered BlueCrest to pay disgorgement in the amount of $107,560,200, prejudgment interest in the amount of $25,154,306, and a civil penalty in the amount of $37,285,494 to the SEC. In addition, in anticipation of the institution of these proceedings, the Respondents have submitted Offers of Settlement, which the Commission has determined to accept.

- **See a copy of the BlueCrest Capital Management Limited Order**
- **See a copy of the SEC Press Release**

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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