

Investment Management Regulatory Update

March 30, 2021

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COVID-19 Update

Please refer to Davis Polk's "[Coronavirus Updates](#)" webpage for content related to the outbreak.

Rules and Regulations

Effective Date Set for Final Rule on Registered Fund Valuations

The Securities and Exchange Commission ("**SEC**") published in the Federal Register the adoption of Rule 2a-5 under the Investment Company Act of 1940, as amended (the "**1940 Act**") addressing valuation practices and the role of the board of directors with respect to the fair value of investments of a registered investment company or business development company. The final rule is effective March 8, 2021 with a compliance date on September 8, 2022. For a discussion of the final rule, see the December 30, 2020 [Investment Management Regulatory Update](#).

- [SEC Release on Fund Valuation Rule](#)

Effective Date Set for Modernized Marketing Rule for Investment Advisers

The SEC published in the Federal Register the adoption of 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 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. The Amendments are effective May 4, 2021 with a compliance date on November 4, 2022. Davis Polk has issued a [client alert](#) and will publish a client memorandum which will include a more detailed discussion of the Amendments.

- [SEC Release on Marketing Rule](#)

SEC Staff Statement on Registered Fund Cross Trading

On March 11, 2021, the staff of the Division of Investment Management issued a statement soliciting feedback on registered fund cross trading under Rule 17a-7 in light of the recent adoption of Rule 2a-5 under the 1940 Act (the “**Valuation Rule**”) regarding registered fund valuation practices. The Valuation Rule incorporates a new definition of the term “readily available market quotations” that could affect the conditions for permitted cross trading under Rule 17a-7. The SEC had previously acknowledged, when adopting the Valuation Rule, that market participants currently engaged in cross trading practices that are not consistent with the new definition will need to conform their practices and, accordingly, certain securities that some may have previously viewed as having readily available market quotations under Rule 17a-7 may not meet the new definition in the Valuation Rule, which has a compliance date of September 8, 2022. The SEC also noted at the time that it understood many cross trades were being effectuated in light of certain letters previously issued by the SEC staff regarding the “readily available market quotation” term under Rule 17a-7, among other things, and that it was reviewing these letters to determine whether they should be withdrawn, in whole or in part.

The staff noted in the statement that registered fund cross trading practices have evolved significantly since adoption of Rule 17a-7, and believes it may be appropriate to evaluate whether changes to Rule 17a-7 may be warranted. According to the statement, consideration of amendments to Rule 17a-7 is on the SEC’s rulemaking agenda. As the staff continues to evaluate these matters, it indicated that it is seeking feedback to help it evaluate potential recommendations in this respect. Specifically, the staff is soliciting feedback on the topics and questions listed in the March statement, including information on: (i) current cross trading practices of registered funds, (ii) pricing and liquidity of securities eligible for cross trading under Rule 17a-7, (iii) controls in place to govern cross trading and (iv) impact of registered fund cross trading on market transparency.

- [Staff statement](#)

Industry Update

SEC Division of Examinations Releases Examination Priorities for 2021

On March 3, 2021, the SEC Division of Examinations (“**Division**”), published its examination priorities for 2021 (the “**Exam Priorities**”). The Exam Priorities fall into eight categories: (i) matters of importance to retail investors, including seniors and those saving for retirement; (ii) information security and operational resiliency; (iii) financial technology and digital assets; (iv) anti-money laundering programs; (v) London Inter-Bank Offered Rate (“**LIBOR**”) transition; (vi) focus areas involving registered investment advisers (“**RIAs**”) and investment companies; (vii) focus areas involving broker-dealers and municipal advisors; and (viii) market infrastructure. For a discussion of the 2020 Exam Priorities, please see the January 31, 2020 [Investment Management Regulatory Update](#).

Retail Investors, Including Seniors and Those Saving for Retirement

According to the Exam Priorities, the Division plans to focus on seniors and individuals saving for retirement, including examining firms that provide products and services to those investors. The Exam Priorities noted that the Division will prioritize examinations of intermediaries that serve retail investors, namely RIAs, broker-dealers and dually registered firms, and examinations focused on investments marketed to or designed for retail investors, such as mutual funds and exchange-traded funds (“**ETFs**”), municipal securities and other fixed income securities and microcap securities. Specific areas of focus will include:

Standards of Care. According to the Exam Priorities, the SEC’s “June 2019 adoption of Regulation Best Interest, the Form CRS Relationship Summary and the Interpretation Regarding Standard of Conduct for

Investment Advisers will have a direct impact on the retail investor experience with broker-dealers and RIAs.” The Division stated in the Exam Priorities that it will prioritize examinations of broker-dealers and RIAs to assess compliance with Form CRS, and will continue to focus on assessing RIAs’ fulfillment of their fiduciary duties and on risks associated with fees and expenses, complex products, best execution, and undisclosed or inadequately disclosed compensation arrangements.

Fraud, Sales Practices and Conflicts of Interest. The Division plans to assess, among other things, whether disclosures required by the federal securities laws, including those relating to fees, expenses and conflicts of interest, are made as required and whether a firm’s actions match such disclosures. The Exam Priorities noted that the increased volatility in the market could lead to increased instances of fraudulent conduct. Examinations will review:

- Recommendations and advice given to retail investors, especially senior investors, teachers, people saving for retirement and military personnel. In particular, examinations will focus on recommendations regarding account type, conversations and rollovers as well as the sales practices used by firms for various product types, such as structured products, exchange-traded products, real estate investment trusts, private placements, annuities, digital assets, municipal and other fixed income securities, and microcap securities. The Division will also focus on how firms are complying with the recent changes to the definition of accredited investor when recommending and selling certain private offerings.
- RIA fees and expenses for: (1) advisory fee calculation errors, including, but not limited to, failure to exclude certain holdings from management fee calculations; (2) inaccurate calculations of tiered fees, including failure to provide breakpoints and aggregate household accounts; and (3) failures to refund prepaid fees for terminated accounts. The Exam Priorities noted that breaches of the fiduciary duty of care may arise when an RIA does not aggregate certain accounts when calculating fee discounts in accordance with its disclosures. According to the Exam Priorities, compensation-based conflicts of interest may take many forms, including revenue sharing arrangements between a registered firm and issuers, service providers and others, and direct or indirect compensation to advisory personnel for executing client transactions. The Exam Priorities noted that the Division will prioritize examinations of RIAs operating and utilizing turnkey asset management platforms, with a focus on assessing whether fees and revenue sharing arrangements are adequately disclosed.

Retail-Targeted Investments. According to the Exam Priorities, the Division will continue to prioritize examinations of issues focused on retail investors, including issues related to mutual funds and ETFs, municipal securities and other fixed income securities, and microcap securities. Examinations will review:

- Mutual Funds and ETFs: Financial incentives provided to financial services firms and personnel that may influence the selection of higher cost mutual fund share classes when lower cost classes are available. Examinations will also focus on financial intermediaries’ recommendations and disclosures involving ETFs, including adequacy of risk disclosure, and suitability, particularly in niche or leveraged/inverse ETFs.
- Municipal Securities and Other Fixed Income Securities: Broker-dealer trading activity in municipal and corporate bonds for compliance with best execution obligations; fairness of pricing, mark-ups and mark-downs, and commissions; and confirmation disclosure requirements.
- Microcap Securities: Broker-dealers and transfer agents involved in selling stocks of companies with a market capitalization of under \$250 million, focusing on, among other things: manipulative schemes, compliance with Regulation SHO (governing short sales) and Rules 15c-2 through 15c-6 under the Securities Exchange Act of 1934 (the “**Exchange Act**”), and compliance with anti-money laundering (“**AML**”) obligations

Information Security and Operational Resiliency

According to the Exam Priorities, the Division plans to continue to focus on information security, including, among other things, identifying and addressing security risk, including cyberattack-related risks, and encouraging market participants to actively and effectively engage regulators and law enforcement in this effort. As a result of the COVID pandemic, the Division will also focus on whether firms have taken appropriate measures to: (i) safeguard customer accounts and prevent account intrusions, including verifying an investor's identity to prevent unauthorized account access; (ii) oversee vendors and service providers; (iii) address malicious email activities, such as phishing or account intrusions; (iv) respond to incidents, including those related to ransomware attacks; and (v) manage operational risk as a result of dispersed employees in a work-from-home environment. The Division will also begin reviewing registrants' business continuity and disaster recovery plans again.

Financial Technology and Innovation, Including Digital Assets and Electronic Investment Advice

According to the Exam Priorities, the Division plans to continue to focus on technology development.

Digital Assets: The Division will continue to identify and examine SEC-registered market participants engaged in the digital asset market, with examinations focused on, among other things, whether investments are in the best interests of investors, portfolio management and trading practices, safety of client funds and assets, pricing and valuation, effectiveness of compliance programs and controls, and supervision of employees' outside business activities.

Electronic Investment Advice: For "robo-advisers" and other RIAs that provide services to clients through automated investment tools and platforms, examinations will focus on, among other things: whether firms are operating consistently with their representations, whether firms are handling customer orders in accordance with customer instructions, and compliance around trade recommendations made in mobile applications.

RegTech: For firms that use technology to facilitate compliance with regulatory requirements, the exams will focus on the implementation and integration of RegTech in firms' compliance programs.

AML Programs

The Division will continue to focus on examining broker-dealers and investment companies for compliance with their AML obligations, including "whether firms have established appropriate customer identification programs and whether they are satisfying their [suspicious activity report] filing obligations, conducting due diligence on customers, complying with beneficial ownership requirements, and conducting robust and timely independent tests of their AML programs."

LIBOR Transition

The Division intends to engage with registrants through examinations to assess their understanding of any exposure to LIBOR, their preparations for the expected discontinuation of LIBOR and the transition to an alternative reference rate, in connection with registrants' own financial matters and those of their clients and customers.

Focus Areas Involving RIAs and Investment Companies

According to the Exam Priorities, the Division will continue to assess the compliance programs of RIAs, including the appropriateness of account selection, portfolio management practices, custody and safekeeping of client assets, best execution, fees and expenses, and valuation of client assets. The exams will prioritize RIAs that have not been examined for a number of years to focus on updates to compliance programs in light of growth of businesses or changes in business models.

The Division plans to continue to review whether RIAs' compliance programs and their policies and procedures are reasonably designed, implemented and maintained. The Division will also continue to prioritize examinations of RIAs that are dually registered as, or are affiliated with, broker-dealers, or have

supervised persons who are registered representatives of unaffiliated broker-dealers, focusing on, among other things: conflicts of interest that arise from compensation arrangements and outside business activities, best execution, and prohibited transactions.

According to the Exam Priorities, the Division will also focus on “products and services that are referred to by a variety of terms such as sustainable, socially responsible, impact, and ESG conscious.” Examinations will review the “consistency and adequacy of the disclosures RIAs and fund complexes provide to clients regarding these strategies, determine whether the firms’ processes and practices match their disclosures, review fund advertising for false or misleading statements, and review proxy voting policies and procedures and votes to assess whether they align with the strategies.”

Mutual Funds and ETFs: Examinations will review “disclosures to investors, valuation, filings with the [SEC], personal trading activities, contracts and agreements, and will include a review of fund governance practices and compliance programs.” According to the Exam Priorities, the Division will focus on, among other things:

- Valuation and the resulting impact on fund performance, liquidity and risk-related disclosures;
- Investments in stressed market sectors due to the pandemic, such as energy, real estate, or bank loans and high yield corporate and municipal bonds;
- Fund and adviser disclosures and practices related to securities lending;
- Liquidity risk management programs (“LRMPs”) to determine whether they are “reasonably designed to assess and manage the funds’ liquidity risk” and implementation of “required liquidity classifications, particularly in light of the recent stresses in the market due to the pandemic;” and
- Money market funds’ compliance with stress-testing requirements, website disclosures and board oversight.

The Division will prioritize examinations of mutual funds or ETFs that have not previously been examined or have not been examined in a number of years, focusing on funds that have instituted advisory fee waivers, and compliance with exemptive relief, e.g., for newly created non-transparent actively managed ETFs.

RIAs to Private Funds: The Division will continue to focus on RIAs that manage private funds, “including a focus on liquidity and disclosures of investment risks and conflicts of interest.” According to the Exam Priorities, the Division will focus on advisers to private funds with a higher concentration of structured products, such as collateralized loan obligations and mortgage backed securities. Examinations will focus on whether such funds involve higher risks of holding non-performing loans and loans with higher default risks than are disclosed to investors. The Division will also examine advisers to private funds investing in portfolio companies where there may have been material impacts due to recent economic conditions (e.g., real estate-related investments).

The Exam Priorities also set out focus areas for examinations involving broker-dealers, municipal advisors and market infrastructure participants, such as clearing agencies and national securities exchanges. According to the Division, the areas of focus in the Exam Priorities are not comprehensive, and they remain open to addressing emerging and exigent risks to investors and the financial markets as they arise.

- [See a copy of the Press Release](#)
- [See a copy of the Exam Priorities](#)

SEC Division of Examinations Risk Alert on Digital Asset Securities

On February 26, 2021, the Division issued a Risk Alert regarding the Division's continued focus on digital assets, which it identified as presenting unique risks to investors. The alert reflects the observations of Division staff during examinations of investment advisers, broker-dealers and transfer agents regarding digital assets, though this summary will focus on the takeaways for investment advisers. In particular, the Division staff noted six primary areas of focus in its examinations of investment advisers investing client assets in digital assets, including:

- *Advisers' portfolio management*, with particular emphasis on:
 - The classification of digital assets managed on behalf of clients (e.g., as securities or not);
 - Due diligence conducted by advisers on digital assets (e.g., whether the adviser understands the digital asset, wallets, or other devices or software that it uses to interact with the relevant digital asset network or application in addition to the liquidity and volatility of the specific digital asset);
 - The evaluation and mitigation of risks attributable to trading venues and trade execution or settlement facilities (e.g., with respect to security breaches, fraud, insolvency, market manipulation, the quality of market surveillance, KYC/AML procedures, and compliance with applicable rules and regulations);
 - The adviser's management of the risks associated with "forked" and "airdropped" digital assets (e.g., allocations across client accounts, potential conflicts of interest and other related issues); and
 - General compliance by the adviser with fiduciary duties in providing investment advice, across all client types.
- *Books and records policies and practices*, specifically making and keeping accurate books and records (including recording trading activity in compliance with applicable requirements) and ensuring that the adviser's policies take into account the recordation and notification practices of the digital asset trading platform(s) used by the adviser, which may vary greatly.
- *Custody*, including compliance with rule 206(4)-2 (the "**Custody Rule**") under the Advisers Act, where applicable. Regardless of the manner in which digital assets are stored, the Division staff will review any occurrences of unauthorized transactions, including theft, controls put in place by the adviser around the safekeeping of digital assets (e.g., employee access to private keys and trading platform accounts), the sufficiency of business continuity plans where key personnel have exclusive access to private keys, the extent to which the adviser has evaluated the harm of private key loss, the reliability of the software used to interact with applicable digital asset networks, storage of digital assets on trading platforms with third-party custodians and security procedures related to wallets.
- *Disclosures*, including a review of investor disclosures across a variety of formats (e.g., marketing materials, fund documents and regulatory brochures and supplements) to ensure sufficient discussion of the unique risks associated with digital assets and specifically the disclosure around the complexity of the products and technology underlying such assets, technical, legal, market and operational risks (including around custody and cybersecurity), price volatility, illiquidity, valuation methodology, related-party transactions and conflicts of interest.
- *Pricing of client portfolios*, including, among other things, the valuation methodologies utilized by the adviser, particularly those used to determine principal markets, fair value, valuation after significant events and the recognition of forked and airdropped digital assets, as well as

disclosure around valuation methodologies, advisory fee calculations and the impact valuation practices have on such fees.

- *Registration Issues*, including, among other things, understanding how the adviser calculates its regulatory assets under management and characterizes the digital assets in the pooled vehicles it manages as well as client status. For private funds managed by an adviser, this review would also involve understanding how the funds determine applicable exemptions from registration as investment companies.

The Division noted that by issuing this risk alert it hopes to encourage advisers and other market participants to take account of their current practices, policies and procedures and consider potential improvements in their supervisory, oversight, and compliance programs.

- **Risk Alert**

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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