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COVID-19 Updates

Please refer to Skadden's COVID-19 Publications and Webinars for information regarding the ongoing effects of the COVID-19 pandemic on the global economy.

Update to Closed-End Fund Activism: Activism Campaign Roundup

Activist closed-end fund investors — such as Bulldog Investors, LLC; Special Opportunities Fund, Inc., a closed-end fund advised by Bulldog; Saba Capital Management, L.P. (Saba); and Karpus Management, Inc. — continue to promote their agendas during the 2021 proxy season. The below provides an overview of certain activism activity during the 2021 proxy season. There are other matters of which we are aware but cannot comment on.

Voya Prime Rate Trust announced that at a special meeting of shareholders held on May 21, 2021, shareholders of the fund voted in favor of a proposal to approve a new investment management agreement between the fund and Saba as well as certain changes to the fund's investment objective and policies, including, among other changes, the removal of the fund's fundamental investment restriction relating to investing in other investment companies. Saba will assume responsibility for providing investment management services to the fund effective as of close of business on June 4, 2021. In connection with the fund's 2020 annual meeting of shareholders, Saba nominated its own slate of trustees and submitted a proposal requesting that the fund board consider authorizing a self-tender offer for 40% of the outstanding shares of the fund at or close to net asset value. The fund announced that shareholders voted to elect Saba's slate of directors and that the self-tender shareholder proposal passed.

On April 12, 2021, Nuveen Global High Income Fund announced that at the fund's 2021 annual meeting of shareholders, a majority of votes cast by shareholders voted for the fund's current Class III trustees who were up for election.

On April 8, 2021, First Trust High Income Long/Short Fund announced that at the fund's 2021 annual meeting of shareholders, shareholders of the fund voted to reelect two current trustees and voted against a shareholder proposal by Saba to terminate all investment advisory and management agreements pertaining to the fund.

Gary Gensler Named New SEC Chair

On April 14, 2021, the U.S. Senate confirmed President Biden's nomination of Gary Gensler to chair the Securities and Exchange Commission (SEC).

SEC Staff Grants Relief Under Rule 14a-8(b)(1)

On February 5, 2021, the staff of the SEC's Division of Investment Management issued a letter granting no action relief to Templeton Emerging Markets Income Fund to exclude a Rule 14a-8 shareholder proposal requesting that the fund board consider authorizing a self-tender offer for at least 30% of the fund's outstanding common shares at net asset value. The staff wrote:

> The Fund argues that the Proposal may be excluded from the Proxy Materials, as permitted by Rule 14a-8(b)(1) under the Securities Exchange Act of 1934, as amended, because the Proponent does not hold securities entitled to be voted on the Proposal. You represent that the Proponent holds securities that are entitled to vote only on certain matters, which do not include the subject of the Proposal. Rule 14a-8(b) requires that in order to be eligible to have a proposal included in a company's proxy materials, a shareholder must hold "securities entitled to be voted on the proposal."
>
> Based on the information you provided, there appears to be some basis for your view that the Proposal may be excluded in reliance on Rule 14a-8(b)(1). Accordingly, we will not recommend enforcement action to the Commission if the Fund excludes the Proposal from its Proxy Materials in reliance on Rule 14a-8(b)(1).

This letter is consistent with letters issued by the staff in 2020 to Dividend and Income Fund (April 10, 2020) and First Trust Senior Floating Rate Income Fund II (June 17, 2020), in which the staff permitted the funds to exclude shareholder proposals pursuant to Rule 14a-8(b)(1) in circumstances where the funds' governing documents did not permit the shareholder proponent to vote on the subject matter of such proposal. For more information regarding these letters, see our discussion entitled "SEC Staff Grants No Action Relief to Delaware Statutory Trust in Recognition of the Principle That State Law Governs Matters of Shareholder Governance Absent Conflict With Federal Law" in our December 2020 newsletter.

SEC Reopens Universal Proxy Comment Period

On April 16, 2021, the SEC issued a release reopening the comment period on its proposal to require the use of universal proxy cards in all nonexempt solicitations in connection with contested director elections (Universal Proxy Proposal).

Background

On October 26, 2016, the SEC issued a proposing rule release on the Universal Proxy Proposal, which, if adopted, would give shareholders the ability to vote for their preferred combination of nominees from competing slates without having to attend the shareholder meeting. Under the Universal Proxy Proposal:

- Companies and dissidents would be required to provide shareholders with a proxy card that lists the names of all nominees, clearly distinguishing between company nominees, dissident nominees and proxy access nominees and listing nominees within each group in alphabetical order.
- A nominee for election as a director would have to agree to be named in any proxy statement relating to a company's next meeting of shareholders at which directors are to be elected.
- Management and dissidents would be required to provide each other with timely notice of the names of their nominees (separate from any notice required under a company's advance notice bylaw). Dissidents also would be subject to a filing deadline for their definitive proxy statement and required to solicit shareholders representing at least a majority of the shares entitled to vote on the election of directors.
- The SEC's "short slate rule," permitting dissidents to nominate candidates for a minority of board seats and identify company nominees they would not vote for, would be eliminated as no longer necessary under a mandatory universal proxy card regime.

The SEC also proposed amendments requiring companies with majority voting standards in director elections to provide "against" and "abstain" options on proxy cards and requiring companies with plurality voting standards to disclose the effect of a "withhold" vote.

The Universal Proxy Proposal would not apply to election contests at registered investment companies or business development companies (BDCs).

The comment period on the Universal Proxy Proposal ended on January 9, 2017.

Reopened Comment Period

The SEC explained that the reopened comment period is intended to allow interested parties to submit further comments and data on the Universal Proxy Proposal as well as additional comments on the questions raised in the reopening release in light of market developments since the publication of the Universal Proxy Proposal in 2016.

With respect to investment companies, the SEC noted developments in corporate governance matters affecting funds, particularly registered closed-end funds and BDCs. The SEC stated:

> Contested elections of directors for registered closed-end funds and BDCs have been more common in recent years, as compared to the few years preceding the 2016 Release. Other corporate governance developments relating to funds since the 2016 Release include, for example, an increase in interest by closed-end funds in including provisions in their governing documents requiring that directors be elected by a majority of all shares outstanding, rather than of shares voted, and funds opting into a state's control share acquisition statute.

In light of these developments, the SEC is requesting comments on the following questions relating to investment companies:

- [W]e are considering whether we should apply the proposed universal proxy card requirements to registered closed-end funds and BDCs. We request comment on the extent to which the similarities or differences among open-end funds, registered closed-end funds and BDCs should result in similar or differential application of the universal proxy rules.
- How commonly do registered closed-end funds and BDCs utilize a unitary structure, where a single board oversees every fund in a fund complex? How frequently do they use a cluster board structure, where two or more boards each oversee a different set of funds in the complex? Do the same concerns noted by commenters about a dissident director disrupting this cluster board structure in open-end fund complexes apply to these registered closed-end funds and BDCs? To the extent a universal proxy card requirement would cause disruptions for open-end funds, closed-end funds or BDCs, are the costs of these disruptions justified by the benefits to shareholders of the ability to vote by proxy as if they were attending the shareholder meeting in person? To what extent would disclosure to shareholders in the proxy materials regarding such potential losses in efficiency be sufficient to mitigate the risk of such disruptive outcomes?
- We have observed that a large fraction of the recent contests at closed-end funds involve a dissident contesting elections of multiple funds in the same fund complex. To what extent is any potential disruption to unitary or cluster boards different in situations where a dissident is seeking election of directors for multiple funds in a complex? How, if at all, should such contests affect our consideration of whether to extend the mandatory universal proxy card requirement to some or all funds?
- In reviewing proxy contests since 2016, we observed that many closed-end funds subject to a proxy contest utilized a classified board structure, meaning that only a minority of the board was up for election each year. Accordingly, even when dissidents ran a full slate of directors, such directors, if elected, would still only represent a minority of the board. How common is a classified board structure for registered closed-end funds and BDCs? How, if at all, does such a structure affect contested elections, or our assessment of whether the Proposed Rules should apply to registered closed-end funds or BDCs? In particular, does a classified board structure itself increase the chance of dissident directors disrupting unitary and cluster boards, regardless of whether funds with classified boards are subject to the Proposed Rules?
- We request any data or examples that would help us to better ascertain the degree of interest by shareholders in funds in splitting their votes in contested elections.
- In the 2016 Release, the SEC noted that the types of changes pursued by dissidents at registered closed-end funds and BDCs, such as converting a closed-end fund to an open-end fund, have tended to be binary in nature. Are there other types of goals or compromise approaches that dissidents have pursued at such registrants in more recent years? To what extent are mixed board outcomes, where some but not all of a dissident's nominees are elected, an effective means of achieving dissident goals in contests at registered closed-end funds and BDCs?
- If we extended the Proposed Rules to some or all funds, would a different minimum solicitation requirement be appropriate for these registrants than for others? If so, what threshold would be appropriate, and why? How, if at all, would the appropriate threshold differ across open-end funds, registered closed-end funds and BDCs? How does the concentration of ownership and types of holders of open-end funds, registered closed-end funds and BDCs differ from other registrants that may be the subject of proxy contests? Does the solicitation process differ for contests at open-end funds, registered closed-end funds or BDCs as compared to other registrants? How would the costs and other effects of the minimum solicitation requirement differ when applied to contests at these registrants as opposed to other registrants?
- As discussed above, we have observed recent developments in the area of corporate governance affecting funds, particularly registered closed-end funds and BDCs. How, if at all, are such developments, or other developments, relevant to our assessment of whether the Proposed Rules should apply to registered closed-end funds and BDCs? Would a universal proxy card facilitate shareholder voting in registered closed-end fund and BDC elections?
- What would be the costs and benefits and other economic effects of applying the Proposed Rules to registered closed-end funds and BDCs, or more broadly to other kinds of funds? To what extent do any developments since the 2016 Release affect the anticipated costs and benefits? How, if at all, have any such developments changed the differences in the likely economic effects of applying the Proposed Rules to some or all funds as compared to operating companies?
- As noted above, we have not observed any proxy contests in open-end funds since 2000. Would there be benefits to applying the Proposed Rules to all funds, including open-end funds, to the extent open-end funds do face proxy contests? What would be the costs of applying the Proposed Rules to open-end funds in the absence of contests?

- The SEC noted in the 2016 Release that in the absence of the proposed universal proxy card requirement applying to funds, the current rules would continue to apply, including the short slate and bona fide nominee rules. Do commenters believe that these rules are necessary or appropriate for any fund not required to use a universal proxy card? Or does the lack of proxy contests in open-end funds indicate that it would be appropriate to rescind these rules even if we do not extend the application of the Proposed Rules to open-end funds?
- There are registered closed-end funds and BDCs that, like open-end funds, do not hold annual meetings to elect directors because of their state of incorporation or type of corporate entity, or because they are not listed on an exchange. If we were to exclude open-end funds from the Proposed Rules because of the lack of annual meetings, should the exclusion apply to registered closed-end funds and BDCs that do not hold annual meetings? Should such funds continue to be subject to the short slate and bona fide nominee rules?
- Are there any other developments since 2016 we should consider in our assessment of whether the Proposed Rules should apply to open-end funds, closed-end funds or BDCs? What are the economic effects of any such developments?

The reopened comment period closes on June 7, 2021.

See the SEC Release (No. 34-91603).

NYSE Withdraws Proposed Rule Change To Amend Limits on Investments in Private Funds by Listed Closed-End Fund Investments

On May 6, 2021, the NYSE withdrew a proposed rule change to amend Section 102.04 of the NYSE Listed Company Manual to establish limits on investments in private funds by listed closed-end funds. Section 102.04(A) currently does not include an explicit restriction on the kinds of investments a listed closed-end fund may include in its portfolio. In contrast, Rule 22e-4 of the Investment Company Act of 1940, as amended (1940 Act), provides that no open-end fund may acquire any illiquid investment if, immediately after the acquisition, the fund would have invested more than 15% of its net assets in illiquid investments that are assets. We understand that through the listing approval process, the NYSE, in response to guidance from the SEC Division of Trading & Markets, has generally taken the position that a closed-end fund that invests in private funds may not be listed on the NYSE. The proposed rule change had been announced on April 20, 2021, and, under the proposal, Section 102.04(A) would have been amended to provide listed closed-end funds a limited ability to invest in private funds.

See the notice of withdrawal (SEC Release No. 34-91871) and the NYSE proposal (Form 19b-4).

SEC Adopts Modernized Marketing Rule for Investment Advisers

On December 22, 2020, the SEC adopted amendments to the rules that govern investment adviser marketing under the Investment Advisers Act of 1940 (the Advisers Act), which had not be substantively updated since their adoption over forty years ago. The amendments create a single, merged rule that replaces Rule 206(4)-1 (advertising rule) and Rule 206(4)-3 (cash solicitation rule). The final marketing rule will apply to communications sent to clients and private fund investors but will not apply to advertisements about registered investment companies or BDCs. According to the adopting release, the final marketing rule "contains principles-based provisions designed to accommodate the continual evolution and interplay of technology and advice." The SEC also adopted amendments to Form ADV to provide the SEC with additional information about advisers' marketing practices and related amendments to the books and records rule under the Advisers Act.

The marketing rule became effective May 4, 2021, and institutes an 18-month transition period before investment advisers are required to comply with the new rule.

The SEC staff also recently released FAQs relating to the adoption of Rule 206(4)(1) that address the compliance date and inclusion of interim performance information in an advertisement. See the FAQs.

Marketing Rule

Definition of Advertisement

Under the final marketing rule, the definition of "advertisement" contains two prongs: one that captures traditional advertising communications and another that governs traditional solicitation activities.

The first prong includes any direct or indirect communication an investment adviser makes to more than one person, or to one or more persons if the communication includes hypothetical performance, that offers the investment adviser's investment advisory services with regard to securities to prospective clients or investors in a private fund advised by the investment adviser or offers new investment advisory services with regard to securities to current clients or investors in a private fund advised by the investment adviser, but does not include: (i) extemporaneous, live, oral communications; (ii) information contained in a statutory or regulatory notice, filing, or other required communication, provided that such information is reasonably designed to satisfy the requirements of such notice, filing or other required communication; or (iii) a communication that includes hypothetical performance that is provided: (a) in response to an unsolicited request for such information from a prospective or current client or investor in a private fund advised by the investment adviser, or (b) to a prospective or current investor in a private fund advised by the investment adviser in a one-on-one communication.

The second prong includes any endorsement or testimonial for which an investment adviser provides compensation, directly or indirectly, but does not include any information contained in a statutory or regulatory notice, filing or other required communication, that is reasonably designed to satisfy the requirements of such notice, filing or other required communication.

Registered Investment Companies and BDCS

The proposed amendments would have generally applied to advertisements sent to investors in "pooled investment vehicles," as defined in Rule 206(4)-8 of the Advisers Act, and would have included an exclusion for RICs and BDCs. Because the new marketing rule applies only to "private funds," the SEC determined that the proposed exclusion for advertisement and marketing materials of RICs or BDCs was not required.

General Prohibitions

The SEC also adopted general prohibitions of certain marketing practices. In any advertisement, an adviser may not:

1. include any untrue statement of a material fact, or omit to state a material fact necessary in order to make the statement made, in the light of the circumstances under which it was made, not misleading;
2. include a material statement of fact that the adviser does not have a reasonable basis for believing it will be able to substantiate upon demand by the SEC;
3. include information that would reasonably be likely to cause an untrue or misleading implication or inference to be drawn concerning a material fact relating to the investment adviser;
4. discuss any potential benefits to clients or investors connected with or resulting from the investment adviser's services or methods of operation without providing fair and balanced treatment of any material risks or material limitations associated with the potential benefits;
5. include a reference to specific investment advice provided by the investment adviser where such investment advice is not presented in a manner that is fair and balanced;
6. include or exclude performance results, or present performance time periods, in a manner that is not fair and balanced; or
7. include information that is otherwise materially misleading.

To establish a violation of the marketing rule, the SEC will not need to demonstrate that an investment adviser acted with scienter; negligence is sufficient.

Testimonials and Endorsements

The marketing rule permits investment advisers to include "testimonials" and "endorsements" in an advertisement, subject to the rule's general prohibitions and certain additional disclosures and conditions. The definitions of "testimonial" and "endorsement" under the final rule are intended to capture activities previously covered by the cash solicitation rule.

Definition of Testimonial

Under the final rule, "testimonial" means any statement by a current client or investor in a private fund advised by the investment adviser: (i) about the client or investor's experience with the investment adviser or its supervised persons; (ii) that directly or indirectly solicits any current or prospective client or investor to be a client of, or an investor in a private fund advised by, the investment adviser; or (iii) that refers any current or prospective client or investor to be a client of, or an investor in a private fund advised by, the investment adviser.

Definition of Endorsements

Under the final rule, "endorsement" means any statement by a person other than a current client or investor in a private fund advised by the investment adviser that: (i) indicates approval, support, or recommendation of the investment adviser or its supervised persons or describes that person's experience with the investment adviser or its supervised persons; (ii) directly or indirectly solicits any current or prospective client or investor to be a client of, or an investor in a private fund advised by, the investment adviser; or (iii) refers any current or prospective client or investor to be a client of, or an investor in a private fund advised by, the investment adviser.

Disclosure, Oversight and Disqualification Provisions

The marketing rule prohibits the use of testimonials and endorsements in an advertisement, unless the adviser satisfies certain disclosure, oversight and disqualification requirements:

- **Disclosure:** Advertisements must clearly and prominently disclose whether the person giving the testimonial or endorsement (the promoter) is a current client or investor and whether the promoter is compensated. Additional disclosures are required regarding compensation and conflicts of interest.
- **Oversight and written agreement:** An adviser that uses testimonials or endorsements in an advertisement must oversee compliance with the marketing rule. An adviser also must enter into a written agreement with promoters, except where the promoter is an affiliate of the adviser or the promoter receives de minimis compensation (*i.e.*, less than $1,000 during the preceding twelve months).
- **Disqualification:** The rule prohibits certain "bad actors" from acting as promoters.

Third-Party Ratings

The marketing rule permits third-party ratings under certain circumstances.

Performance Information Generally

The marketing rule prohibits inclusion of the following in any advertisement:

- gross performance results, unless net performance results are also presented;
- any performance results, unless they are provided for specific time periods (one-year, five-year and 10-year periods) in most circumstances;
- any express or implied statement that the calculation or presentation of performance results has been approved or reviewed by the SEC;

- related performance results from fewer than all portfolios with substantially similar investment policies, objectives and strategies as those being offered in the advertisement, with limited exceptions;
- any extracted performance, unless the advertisement provides, or offers to provide promptly, the performance results of the total portfolio from which the performance was extracted;
- hypothetical performance, unless the adviser satisfies certain conditions, as discussed below; and
- predecessor performance, unless there is sufficient similarity between the personnel and the accounts at the predecessor adviser and the personnel and the accounts at the advertising adviser. In addition, the advertising adviser must include all relevant disclosures clearly and prominently in the advertisement.

Hypothetical Performance

"Hypothetical Performance" is defined under the marketing rule to mean "performance results that were not actually achieved by any portfolio of the investment adviser," and explicitly includes, but is not limited to, performance of model portfolios, backtested performance, and targeted or projected performance. Hypothetical performance excludes certain interactive analysis tools and predecessor performance. An investment adviser may include hypothetical performance if it satisfies the following conditions:

- The adviser must adopt and implement policies and procedures reasonably designed to ensure that the hypothetical performance information is relevant to the likely financial situation and investment objectives of the intended audience of the advertisement. Here, the marketing rule does not prescribe specific policies and procedures and instead provides advisers with flexibility to develop policies and procedures tailored to their operations and investor base. The SEC cautioned in the adopting release that "hypothetical performance directed to mass audiences generally will not be able to meet this standard."
- The adviser must provide sufficient information to enable the intended audience to understand the criteria used and assumptions made in calculating such hypothetical performance. Advisers will not be required to provide information that would be necessary to allow the intended audience to replicate the performance (*e.g.*, confidential or propriety information). However, advisers should provide information that includes any assumptions on which the hypothetical performance rests, which may include assumptions that future events will occur.
- The adviser must provide (or, if the intended audience is a private fund investor, provide or offer to provide promptly) sufficient information to enable the intended audience to understand the risks and limitations of using hypothetical performance in making investment decisions.

Amendments to the Books-and-Records Rule and Form ADV

The SEC adopted amendments to the books-and-records rule (Rule 204-2) to reflect the marketing rule. In addition, the SEC amended Form ADV to require advisers to provide additional information regarding their marketing practices to help facilitate the SEC's inspection and enforcement capabilities.

Withdrawal of SEC Staff Guidance

The SEC staff will withdraw certain no action letters and other guidance that have either been incorporated into the marketing rule or are no longer applicable.

See the SEC Release (No. IA-5653) for the final rule.

SEC Division of Investment Management Staff Statement on Cross Trading

On March 11, 2021, the staff of the SEC's Division of Investment Management issued a statement addressing cross-trading practices under Rule 17a-7 of the 1940 Act and requesting feedback on ways to enhance the regulatory regime governing cross trades. In the statement, the staff noted that consideration on potential amendments to Rule 17a-7 is on the SEC's rulemaking agenda.

Background

On December 3, 2020, the SEC adopted new Rule 2a-5 under the 1940 Act, which establishes requirements for determining fair value in good faith for purposes of the 1940 Act, and new Rule 31a-4, which establishes relevant record-keeping requirements to support fair value determinations. Rules 2a-5 and 31a-4 became effective on March 8, 2021, with a compliance date of September 8, 2022.

Readily Available Market Quotations

Rule 2a-5 provides that a market quotation is "readily available only when that quotation is a quoted price (unadjusted) in active markets for identical investments that the fund can access at the measurement date, provided that a quotation will not be readily available if it is not reliable." The SEC explains:

> This definition is consistent with the definition of a level 1 input in the fair value hierarchy outlined in U.S. GAAP … a security will be considered to have readily available market quotations if its value is determined solely by reference to these level 1 inputs. Fair value, as defined in the [1940] Act and further defined in rule 2a-5, therefore must be used in all other circumstances.

In the adopting release, the SEC addressed concerns raised by commenters regarding the application of the new definition of readily available market quotations on cross trades under Rule 17a-7. Rule 17a-7 permits purchase or sale transactions between a fund and certain affiliates (referred to as cross trades) if certain protective conditions are met. Among those conditions, Rule 17a-7 generally requires that cross trades (i) involve a security for which market quotations are readily available and (ii) be effected at the independent current market price of the security.

The SEC reiterated that the definition of readily available market quotations will apply in all contexts under the 1940 Act and the rules thereunder, including Rule 17a-7, and accordingly, "certain securities that had been previously viewed as having readily available market quotations and being available to cross trade under rule 17a-7 may not meet our new definition and thus would not be available for such trades." For example, the SEC explained that "evaluated prices," "indications of interest" and "accommodation quotes" would not be "readily available market quotations" under Rule 17a-7. Compliance with the definition of readily available market quotations may require funds to reevaluate or change their cross-trading practices. The SEC acknowledged that many cross trades are executed in reliance on certain SEC no action letters and that the SEC staff is reviewing these letters to determine whether to withdraw them, or portions thereof. The SEC separately noted that consideration of potential updates to Rule 17a-7 is on the SEC's rulemaking agenda and welcomed public input.

Statement

The SEC staff acknowledged that cross-trading practices have evolved over the last several decades. In the statement, the staff identified the following four areas where industry feedback would be particularly helpful as the staff evaluates appropriate changes to Rule 17a-7.

- **Current cross-trading practices:** Under what circumstances do funds currently engage in cross trading? To what extent do funds' current cross trades not have readily available market quotations as defined in the Valuation Rule? What amount of cross trading occurs between two registered investment companies as compared to cross trading between a registered investment company and another type of affiliate? What types of securities do funds currently cross trade? What types of securities do advisers believe they could cross trade under current Rule 17a-7, but choose not to rely on the rule and instead to trade in the market? What types of securities would advisers like to cross trade but believe they cannot under the current Rule 17a-7?
- **Pricing and liquidity of securities eligible to cross trade:** What are the advantages and disadvantages of the threshold requirement in Rule 17a-7 that a security have a "readily available market quotation"? What sources of independent current market prices are used to cross trade securities under Rule 17a-7? What are the liquidity characteristics of securities that funds currently cross trade? Are cross-traded securities valued in the same manner under Rule 17a-7 as they are under Section 2(a)(41) of the 1940 Act? What other criteria for the transactions would protect against conflicts of interest or other risks of cross trades?
- **Controls:** What kinds of controls do advisers have in place to govern cross trading? What controls do advisers have in place to assess whether a cross trade is consistent with the adviser's fiduciary obligation to its clients and is in the best interest of both the buying and selling fund? What controls do funds have in place to assess whether a cross trade is consistent with the investment policy of both the buying fund and the selling fund?
- **Market transparency:** How does cross trading affect market transparency? How might transparency be enhanced for all market participants? To what extent might cross trades affect market efficiency because they are not publicly reported?

Commissioner Elad L. Roisman also issued a separate statement the same day, supporting of the staff's decision to seek feedback on Rule 17a-7. He wrote:

> During the comment process for [Rule 2a-5] … we heard that Rule 2a-5 and its definition of "readily available market quotation" would likely affect the ability of funds to trade fixed income securities with their affiliates. These were important concerns and remain so today.
>
> I am grateful that the staff is moving forward in reviewing Rule 17a-7 and prioritizing questions related to fixed income in particular. This past year, we have all seen that our fixed income markets are critical to the functioning of our other securities markets and our economy more broadly. I look forward to hearing insights from commenters about how we can facilitate fixed income trading in ways that benefit investors and our markets.

The staff requested that comments be submitted to the staff no later than April 12, 2021. See the March 11, 2021, statement on cross trading.

SEC Issues Risk Alert Highlighting Focus on Digital Assets

On February 26, 2021, the staff of the SEC's Division of Examinations (formerly, the Office of Compliance Inspections and Examinations) issued a risk alert offering insight into the division's examinations of investment advisers, broker-dealers, national securities exchanges and transfer agents that engage in digital asset-related activities.[1] The staff explained that the alert is intended to provide transparency for industry participants seeking to engage in digital asset-related activities and to assist firms in developing and enhancing their compliance programs.

While the alert highlights the division's continued focus on digital assets that are securities, it does not provide further insight into whether and to what degree the SEC intends to seek to apply the constructs of the various federal securities laws to digital assets that are not securities under the Securities Act of 1933 (Securities Act). Additionally, whether digital assets will be analyzed differently under the 1940 Act and the Advisers Act, which define "securities" more broadly than the Securities Act and the Securities Exchange Act of 1934 (Exchange Act), remains an open question.

Investment Advisers

The alert notes that the division's examinations of investment advisers will focus on regulatory compliance associated with portfolio management, books and records, custody, disclosures, valuation and registration issues.

Broker-Dealers

The alert notes that the division's examinations of broker-dealers will focus on the safekeeping of funds, registration requirements, anti-money laundering, underwriting and private offerings, disclosure of conflicts of interest and outside business activities related to digital assets.

For a detailed summary of this risk alert, please see our April 2021 publication, "The Distributed Ledger: Blockchain, Digital Assets and Smart Contracts — SEC Issues Risk Alert Highlighting Focus on Digital Assets."

[1] The staff noted that the term "digital asset," as used in the alert, refers to an asset that is issued and/or transferred using distributed ledger or blockchain technology, including, but not limited to, "virtual currencies," "coins" and "tokens," that may or may not meet the definition of "security" under federal securities laws.

ADI 2020-11 Registered Funds' Risk Disclosure Regarding Investments in Emerging Markets

On December 14, 2020, the SEC's Division of Investment Management's Disclosure Review and Accounting Office issued a statement encouraging funds to enhance their risk disclosures related to emerging market investments. In the statement, the SEC staff noted that it has been reviewing the risk disclosures for both actively managed funds with significant exposure to emerging markets and funds that track indices with significant exposure to emerging markets. The SEC staff emphasized that both types of funds may face emerging markets risks that should be disclosed to investors. Accordingly, the staff recommended that these funds, when drafting risk factors, consider the following factors as they relate to the funds' emerging market investments:

- risks related to, among other factors, lack of liquidity, market manipulation concerns, limited reliable access to capital, political risk and foreign investment structures;
- whether and how emerging markets risks arising from differences in regulatory, accounting, auditing, and financial reporting and recordkeeping standards could impede an adviser's ability to evaluate local companies or impact the fund's performance;
- any limitations on the rights and remedies available to the fund, individually or in combination with other shareholders, against portfolio companies;
- if an index fund, whether the index provider will have less reliable or current information when assessing if a company should be included in an index or determining a company's weighting within the index;
- if an index fund, any limitations concerning the adviser's ability to assess the index provider's due diligence process over index data prior to its use in index computation, construction and/or rebalancing; and
- whether the limitations stated above could impact the stated investment objective of the fund.

See the ADI 2020-11 statement.

SEC Division of Examinations Announces 2021 Examination Priorities

On March 3, 2021, the SEC's Division of Examinations announced its 2021 examination priorities. The 2021 report highlights nine areas of focus: (i) retail investors, including seniors and those saving for retirement; (ii) information security and operational resiliency; (iii) financial technology and innovation, including digital assets; (iv) anti-money laundering (AML); (v) London Interbank Offered Rate (LIBOR) transition; (vi) certain matters involving registered investments advisers and investment companies; (vii) certain matters involving broker-dealers and municipal advisors; (viii) market infrastructure (including, clearing agencies, national securities exchanges and transfer agents); and (ix) the Financial Industry Regulatory Authority and the Municipal Securities Rulemaking Board.

The priorities most applicable to funds and registered investment advisers are summarized below.

Retail Investors, Including Seniors and Individuals Saving for Retirement

The division will continue to emphasize the protection of seniors and individuals saving for retirement and prioritize examinations of financial intermediaries that serve retail investors, including registered investment advisers (RIAs), broker-dealers and dual-registered or affiliated firms.

Standards of Care

The division noted that 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." See our September 2019 Investment Management Update for a summary of the rules and interpretations related to standards of conduct for broker-dealers and investment advisers.

- **Regulation Best Interest:** The division will prioritize examinations to assess compliance with Regulation Best Interest (Regulation BI). The division noted that initial examinations focused on the processes on which broker-dealers relied to implement Regulation BI. The division now intends to expand the scope of examinations to focus on assessing whether broker-dealers are making recommendations that they have a reasonable basis to believe are in customers' best interests, and evaluating broker-dealer processes for compliance and alterations made to product offerings. As part of these examinations, the division will conduct enhanced transaction testing involving the evaluation of firm policies and procedures designed to meet additional elements of Regulation BI, the recommendation of rollovers and alternatives considered, complex product recommendations, the assessment of costs and reasonably available alternatives, the impact of sales-based fees on recommendations, and policies and procedures addressing conflicts of interest.
- **RIA fiduciary duty:** The division will continue to examine RIAs to assess whether they have fulfilled their duty of care and duty of loyalty, and focus on risks associated with fees and expenses, complex products, best execution, and undisclosed or inadequately disclosed compensation arrangements.
- **Form CRS:** The division will prioritize examinations of broker-dealers and RIAs to assess compliance with Form CRS.

Fraud, Sales Practices and Conflicts of Interest

The division noted that recent market volatility may lead to increased instances of fraudulent conduct.

Considering the standards of conduct established for financial intermediaries, the division noted that examinations will focus on the appropriateness of recommendations and advice provided to retail investors, with a particular emphasis on: (i) seniors, including recommendations and advice made by entities and individuals targeting retirement communities; (ii) teachers; (iii) military personnel; and (iv) individuals saving for retirement.

Areas of focus will include:

- recommendations regarding account type, conversions 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;
- whether broker-dealers are meeting their legal and compliance obligations when providing retail customers access to complex strategies, such as options trading, and complex products;
- how firms are complying with the definition of "accredited investor" when recommending and selling certain private offerings;
- firms' disclosures regarding their conflicts of interest, including those related to fees and expenses;
- examination of RIAs operating and utilizing turnkey asset management platforms to assess whether fees and revenue sharing arrangements are adequately disclosed; and
- with respect to fees and expenses generally, (i) advisory fee calculation errors, (ii) inaccurate calculations of tiered fees and (iii) failures to refund prepaid fees for terminated accounts.

Retail-Targeted Investments

The division recognized that certain securities products can pose elevated risks when marketed or sold to retail investors, and will continue to prioritize examinations of issues regarding these products. Specifically, the division will focus on the following products:

- **Mutual funds and exchange-traded funds (ETFs):** The division will focus on financial intermediaries' recommendations and disclosures involving ETFs, including adequacy of risk disclosure and suitability, particularly in niche or leveraged/inverse ETFs, and will prioritize the examination of incentives provided to financial services firms and professionals that may influence the selection of higher-cost mutual fund share classes when lower-cost classes are available.
- **Municipal securities and other fixed-income securities:** The division will examine the activities of broker-dealers, underwriters and municipal advisors to assess whether these firms are meeting their respective obligations, and to the extent applicable, in relation to municipal issuer disclosure. In addition, the division will examine broker-dealer trading activity in municipal and corporate bonds for compliance with best execution obligations; fairness of pricing, markups and markdowns, and commissions; and confirmation disclosure requirements, including disclosures relating to markups and markdowns.
- **Microcap securities (market capitalization under $250 million):** The division will continue to prioritize examinations of broker-dealers and transfer agents for compliance with their obligations in the offer, sale and distribution of microcap securities.

Additional Focus Areas Involving RIAs and Investment Companies

RIA Compliance Programs

The division will continue to evaluate the compliance programs of RIAs, including whether their compliance programs and policies are reasonably designed, implemented and maintained, and whether RIAs have appropriately adapted their compliance programs in response to any substantial changes to their business. The division will prioritize RIAs that have never been examined and RIAs that have not been examined for a number of years.

The division will focus on RIA investment strategies that incorporate sustainability and environmental, social and governance factors. The division will review the consistency and adequacy of the disclosures that RIAs and fund complexes provide to clients regarding these strategies, determine whether 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.

Registered Funds, Including Mutual Funds and ETFs

The division will review mutual fund filings and board reports for compliance with regulatory requirements and for valuation issues. With respect to valuation issues, the division will focus on investments in market sectors affected by the pandemic. The division will also review disclosures and practices related to securities lending and will focus on mutual funds' liquidity risk management programs.

The division will prioritize mutual funds or ETFs that have not previously been examined or have not been examined for many years.

In addition, the division plans to review MMFs' compliance with stress test requirements, website disclosures and board oversight.

RIAs to Private Funds

The division noted that over 36% of RIAs manage private funds. The division stated that it will continue to focus on private fund managers and assess compliance risks, including liquidity and disclosures of investment risks and conflicts of interest.

The division will review for, among other things: preferential treatment of certain investors by private fund advisers that have experienced issues with liquidity; portfolio valuations and the resulting impact on management fees; adequacy of disclosure and compliance with the regulatory requirements for cross trades, principal investments or distressed sales; and conflicts around liquidity.

The division also will focus on advisers to private funds with a high concentration of structured products, such as collateralized loan obligations and mortgage-backed securities, to determine whether such funds are at a higher risk for holding nonperforming loans and having loans with a higher default risk than what is disclosed to investors. Additionally, the division will review material impacts on portfolio companies owned by private funds (*e.g.*, real estate related investments) as a result of recent economic conditions.

Information Security and Operational Resiliency

Amid the increase in remote operations in response to the COVID-19 pandemic, which has increased concerns regarding, among other things, endpoint security, data loss, remote access, use of third-party communication systems and vendor management, the division will review whether firms have taken appropriate measures to:

- safeguard customer accounts and prevent account intrusions, including verifying an investor's identity to prevent unauthorized account access;
- oversee vendors and service providers;
- address malicious email activities, such as phishing or account intrusions;
- respond to incidents, including those related to ransomware attacks; and
- manage operational risk as a result of dispersed employees in a work-from-home environment.

The division noted that given the substantial disruptions to normal business operations due to the COVID-19 pandemic, it will continue reviewing registrants' business continuity and disaster recovery plans.

Financial Technology and Innovation, Including Digital Assets

The division expressed its commitment to staying informed about how innovations in financial technology affect registrants and investors.

The division noted that alternative data (data gleaned from nontraditional sources) is increasingly being used by firms, including advisers to private funds and registered-investment companies, as part of their business and investment decision-making processes. The division will examine whether firms are implementing appropriate controls and compliance around the creation, receipt and use of information.

The division will continue to monitor the evolution of the digital asset market. The division stated that examinations of market participants engaged with digital assets will continue to assess the following:

- 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 representatives' activities outside of business.

AML Programs

The division will continue to prioritize examinations of broker-dealers and registered investment companies for compliance with their AML obligations in order to assess, among other things, whether firms:

- have established appropriate customer identification programs;
- are satisfying their filing obligations related to Suspicious Activity Reports;
- are conducting due diligence on customers;
- are complying with beneficial ownership requirements; and
- are 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 both registrants' own financial matters and those of their clients and customers.

See the 2021 examination priorities.

SEC Issues Statement and Requests Comment Regarding the Custody of Digital Asset Securities by Special Purpose Broker-Dealers

On December 23, 2020, in order to encourage innovation around the application of Rule 15c3-3 under the Exchange Act (the Customer Protection Rule) to digital asset securities, the SEC published a statement regarding the custody of digital assets that are securities under U.S. federal securities laws[2] and requested comments by specialized broker-dealers that limit their business to digital asset securities.

The Customer Protection Rule requires a broker-dealer to promptly obtain and thereafter maintain physical possession or control of all fully paid and excess margin securities it carries for the account of customers. In the statement, the SEC acknowledged that market participants have raised questions regarding the application of the Customer Protection Rule to the custody of digital asset securities by broker-dealers. Accordingly, the SEC is requesting public comments to provide the agency and its staff with additional insight into evolving standards and best practices with respect to the custody of digital asset securities, noting that it intends to consider such comments in connection with any future SEC action.

The statement also sets forth the SEC's position that, for a period of five years from the statement's publication date, a special purpose broker-dealer operating under the following circumstances would not be subject to an enforcement action on the basis that the broker-dealer deems itself to have obtained and maintained physical possession or control of customer fully paid and excess margin digital asset securities:

- The broker-dealer has access to the digital asset securities and the capability to transfer them on the associated distributed ledger technology.
- The broker-dealer limits its business to dealing in, effecting transactions in, maintaining custody of and/or operating an alternative trading system for digital asset securities; however, the broker-dealer may hold proprietary positions in traditional securities solely for the purpose of meeting its minimum net capital requirements under Rule 15c3-1 or hedging the risks of its proprietary positions in traditional securities and digital asset securities.
- Before effecting transactions in and maintaining custody of a digital asset security, the broker-dealer establishes, maintains and enforces reasonably designed written policies and procedures to conduct and document analyses of whether the digital asset is a security offered and sold pursuant to an effective registration statement or an available exemption from registration, and whether the broker-dealer meets its requirements to comply with the applicable federal securities laws relating to effecting transactions in the digital asset security.
- The broker-dealer establishes, maintains and enforces reasonably designed written policies and procedures to conduct and document an assessment of the characteristics of a digital asset security's distributed ledger technology and associated network, both prior to undertaking to maintain custody of the digital asset security and at reasonable intervals thereafter.
- The broker-dealer does not undertake to maintain custody of a digital asset security if it is aware of any material security or operational problems or weaknesses with the distributed ledger technology and associated network used to access and transfer the digital asset security, or of other material risks posed to its business by the digital asset security.
- The broker-dealer establishes, maintains and enforces reasonably designed written policies, procedures and controls that are consistent with industry best practices to demonstrate it has exclusive control over the digital asset securities it holds in custody and to protect against the theft, loss, and unauthorized and accidental use of the private keys necessary to access and transfer the digital asset securities.

[2] The SEC defined "digital asset," for purposes of this statement, as "an asset that is issued and/or transferred using distributed ledger or blockchain technology … including, but not limited to, so-called 'virtual currencies,' 'coins,' and 'tokens.'" The SEC noted that a digital asset may or may not meet the definition of a "security" under U.S. federal securities law.

- The broker-dealer establishes, maintains and enforces reasonably designed written policies, procedures and arrangements to:
  - specifically identify, in advance, the steps it will take in response to certain events that could affect its custody of the digital asset securities;
  - allow for it to comply with a court-ordered freeze or seizure; and
  - allow for the transfer of the digital asset securities to another special purpose broker-dealer, trustee, receiver, liquidator or person performing a similar function.
- The broker-dealer provides written disclosures to prospective customers that the firm is deeming itself to be in possession or control of digital asset securities held for the customer for the purposes of Rule 15c3-3(b)(1), based on its compliance with the SEC's statement and the risks of investing in or holding digital asset securities.
- The broker-dealer enters into a written agreement with each customer that sets forth the terms and conditions with respect to receiving, purchasing, holding, safekeeping, selling, transferring, exchanging, maintaining custody of, liquidating and otherwise transacting in digital asset securities on behalf of the customer.

The SEC's statement became effective April 27, 2021.

See the statement (SEC Release No. 34-90788).

SEC Division of Examinations Statement on Recent and Upcoming Regulation BI Examinations

On December 21, 2020, the SEC's Division of Examinations released updated guidance regarding its upcoming examination program involving Regulation BI. See our September 2019 Investment Management Update for a summary of Regulation BI.

Since Regulation BI's June 30, 2020, compliance date, the SEC staff has undertaken preliminary examinations to evaluate compliance with Regulation BI, including assessing whether firms had developed and implemented policies and procedures reasonably designed to comply with both the procedural and substantive requirements of Regulation BI.

Based on its initial assessments, the staff intends to broaden the scope of its examinations in 2021 that focus on Regulation BI's specific requirements, and identified the following examination components of Regulation BI that may be the subject of focus:

- continued evaluation of firm policies and procedures, including evaluating specific firm processes for compliance with the Regulation BI, and alterations to firm product offerings, including the removal of higher-cost products when lower-cost products are available;
- evaluation of how firms have considered costs in making a recommendation, which may include what information is available to firm personnel to identify relevant costs, how any such information has been used and any documentation of the consideration of costs;
- evaluation of the processes firm personnel have used to make recommendations to new customers, including, for example, if a firm recommended a rollover from an employee benefit plan, examiners will assess what information was gathered from new customers, what disclosures were made at the time, how alternatives were considered and what documentation was retained;
- evaluation of the processes firm personnel have used to recommend complex products, including what information was available and used to consider reasonably available alternatives; and
- evaluation of the processes that firms have used to identify and address conflicts related to recommendations.

In the statement, the staff encouraged firms to continue to evaluate their processes and, in particular, to consider whether the initial programs adopted by the June 30, 2020, compliance date are, in practice, reasonably designed to achieve compliance with Regulation BI. The staff cautioned that failure to have adequate written policies and procedures and failure to have adequate supervisory and compliance oversight may indicate recurring issues in violation of Regulation BI.

See the December 21, 2020, Statement by the Division of Examinations.

SEC Division of Investment Management Information Update on Rule 18f-4

On March 30, 2021, the staff of the SEC's Division of Investment Management issued an information update identifying staff guidance that is being withdrawn or modified, effective as of August 19, 2022, in light of new Rule 18f-4 of the 1940 Act. For more information on Rule 18f-3, please see our November 23, 2020, client alert, "SEC Adopts Rules for Use of Derivatives by Registered Investment Companies."

A complete list of the staff letters that have been withdrawn or modified is included in Appendix A to the March 2021 Information Update (IM-INFO-2021-01).

SEC Requests Comments on Potential Reform Measures for Money Market Funds

On February 4, 2021, the SEC published a request for comments on potential reform measures for money market funds (MMFs), as described in a report issued by the President's Working Group on Financial Markets (PWG) on December 22, 2020, entitled "Overview of Recent Events and Potential Reform Options for Money Market Funds" (Report).

PWG Report Findings

The PWG studied the effects of the COVID-19 pandemic on the short-term funding markets. The Report noted that in March 2020, short-term funding markets came under stress due to growing economic concerns related to the pandemic and "an overall flight to liquidity and quality among investors." It further detailed that while government MMFs saw significant inflows in March 2020, the prime and tax-exempt MMF sectors faced significant outflows and increasingly illiquid markets for the funds' assets and, as a result, began to contribute to general stress in short-term funding markets before the Federal Reserve established facilities to support these markets, including MMFs. The Report presented observations that these events occurred despite multiple prior reform efforts to make MMFs more resilient to credit and liquidity stresses. Due to the structural vulnerabilities of prime and tax-exempt MMFs, the PWG stated that it was "incumbent upon financial regulators to examine the events of March 2020 closely, and in particular the role, operation, and regulatory framework for these MMFs, with a view toward potential improvements." The working group proposed the following reform options for prime and tax-exempt MMFs:

- removal of the tie between MMF liquidity and fee and gate thresholds;
- reformed conditions for imposing redemption gates;
- imposition of a minimum balance at risk;
- changes to MMF liquidity management;
- countercyclical weekly liquid asset requirements;
- floating net asset value requirements for all prime and tax-exempt MMFs;
- a swing pricing requirement;
- capital buffer requirements;
- a requirement for liquidity exchange bank membership; and
- new requirements governing sponsor support.

The PWG noted in the Report that it is not currently endorsing a particular measure. Rather, the working group emphasized that any policy reform should be evaluated in terms of its ability to advance the overarching goals of reform, including whether such policy updates:

- effectively address the MMF structural vulnerabilities that contributed to stress in short-term funding markets;
- improve the resilience and functioning of short-term funding markets; and
- reduce the likelihood that official sector interventions and taxpayer support will be needed to halt future MMF runs or to address stresses in short-term funding markets more generally.

Request for Comments

The SEC requested comments on (i) the potential policy measures described in the Report both individually and in combination; (ii) the effectiveness of previously enacted MMF reform; and (iii) the effectiveness of implementing policy measures proposed in the Report in addition to, or in place of, previously enacted reforms. Comments were due April 12, 2021.

See the request (SEC Release No. IC-34188).

Biden Administration's Memo on Regulatory Freeze Pending Review

On January 20, 2021, the Biden administration issued a memorandum to the heads of U.S. executive departments and agencies titled "Regulatory Freeze Pending Review." The memo sets forth President Biden's plan for managing the federal regulatory process at the outset of his administration and requests that executive departments and agencies take certain steps in order to ensure that the president's appointees or designees have the opportunity to review any new or pending rules. Among other things, the memo requests that executive departments and agencies consider postponing for 60 days rules that have been published in the Federal Register or rules issued that have not yet taken effect, with possible further delays beyond the 60-day period.

See the January 20, 2021, Regulatory Freeze Pending Review Memorandum.

Biden Administration's Memo on Modernizing Regulatory Review

On January 20, 2021, the Biden administration issued a memorandum titled "Modernizing Regulatory Review," which directs the director of the Office of Management and Budget, in consultation with representatives of executive departments and agencies, to make "recommendations for improving and modernizing regulatory review." The memo sets forth that these recommendations should provide "concrete suggestions on how the regulatory review process can promote public health and safety, economic growth, social welfare, racial justice, environmental stewardship, human dignity, equity, and the interests of future generations." The memo further outlines that the recommendations should, among other things, ensure that policies "reflect new developments in scientific and economic understanding," account for "regulatory benefits that are difficult or impossible to quantify," and avoid "harmful anti-regulatory or deregulatory effects." The recommendations are also expected to "identify reforms that will promote the efficiency, transparency, and inclusiveness of the interagency review process, and determine an appropriate approach with respect to the review of guidance documents."

See the January 20, 2021, Modernizing Regulatory Review Memorandum.