GODFREY KAHN S.C.

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Investment Management Legal and Regulatory Update

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LATEST DEVELOPMENTS: FUNDS

SEC Adopts New Fair Value Rule

The SEC adopted a new rule under the Investment Company Act codifying fair valuation requirements for registered investment companies. The last time the SEC comprehensively addressed valuation was more than 50 years ago. Rule 2a-5 establishes requirements for making good faith determinations of fair value in accordance with Section 2(a)(41) of the Investment Company Act and clarifies a board's role relating to such determinations. The adopting release makes clear that the rule does not shift the statutory fair valuation responsibilities away from directors, but rather establishes the requirements the board must meet to fulfill its continuing statutory obligations. The new rule will allow boards to delegate fair valuation to the fund's investment adviser, but will require revisions to valuation procedures, the adoption of testing methods and new reporting requirements prior to the compliance date in September 2022.

The rule provides that fair valuation is required where market quotations for a security are not "readily available," which was not previously defined. The new rule provides that a market quotation is "readily available" only when it is a quoted price (unadjusted) in active markets for identical investments that the fund can access at the valuation date, provided that the quotation is reliable. This definition is intentionally similar to the definition of Level 1 inputs used in ASC Topic 820.

The Role of the Board and Valuation Designees. Rule 2a-5 allows a fund board (or a designated committee composed of a majority of independent directors) to designate a "valuation designee" to perform fair value determinations on its behalf by carrying out the fair value functions described below. Alternatively, boards may perform such fair value functions themselves.

"Valuation designee" is defined to include the adviser of a fund (but not the fund's sub-adviser), or an officer of an internally managed fund. Although sub-advisers cannot be valuation designees, the adopting release clarifies that the board or valuation designee is permitted to seek a sub-adviser's assistance in making fair value determinations. In addition, fund boards or valuation designees may seek assistance from other service providers, such as fund administrators or pricing services, to perform back-testing or other functions under Rule 2a-5. The SEC noted that it is critical for the entity actually performing the fair value determinations to owe a fiduciary duty to the fund and be subject to direct board oversight.

A valuation designee is subject to the board's oversight, as the board remains responsible for the fair value determinations required under Section 2(a)(41), and is required to provide the following reports to the board:

- Quarterly reports on material changes or other developments affecting fair valuation and any additional information requested by a board on fair valuation;
- An annual report providing an overall assessment of the adequacy and effectiveness of the fair valuation process; and
- Prompt reports (within five business days) of matters that materially impact the value of a fund's holdings, such as a significant deficiency or material weakness in the design or effectiveness of the valuation designee's fair value determination process, or material errors in the calculation of NAV. The SEC declined to establish a standard for what constitutes a material NAV error, but noted that the industry standard of $0.01 a share or 0.5% of the NAV would not be unreasonable.

The adopting release emphasizes the fact that boards should approach their oversight of the valuation designee's fair value determinations with a "skeptical and objective view that takes account of the fund's particular valuation risks, including with respect to conflicts, the appropriateness of the fair value determination process, and the skill and resources devoted to it." The release states that board oversight cannot be a passive activity, and a board should ask questions and seek appropriate information, including information regarding potential conflicts of interest of the valuation designee and other service providers assisting with the determination of fair values.

Rule 2a-5 requires that valuation designees specify the titles of persons responsible for determining fair value, including a description of their responsibilities. The valuation designee is required to reasonably segregate fair value determinations from fund portfolio managers such that they are not allowed to determine, or effectively determine by exerting substantial influence on, fair values attributed to investments. The adopting release notes that portfolio managers may be important sources of information regarding a security's value and may provide inputs into the fair value determination process, but the segregation requirements will help mitigate their potential conflicts of interest.

Fair Value Functions and Related Procedures. The final rule requires the performance of the following functions by the board or its valuation designee to determine "fair value in good faith:"

- a periodic assessment of material valuation risks (taking into account changes to investments, investment strategies or policies or market events) and conflicts of interest associated with fair value determinations and the management of such risks and conflicts;
- the establishment and periodic review of fair value methodologies and monitoring for circumstances that may necessitate the use of fair value;
- testing of fair valuation methodologies for appropriateness and accuracy such as disposition analysis, which compares a fair value with the price obtained for the security upon its disposition by the fund; and
- evaluating and overseeing any pricing services used and establishing a process for initiating price challenges.

Fair Value Policies and Procedures. The final rule release provides that Rule 38a-1 (the compliance rule) requires a fund's board to approve policies and procedures reasonably designed to prevent violations of Rule 2a-5's requirements. As such, Rule 2a-5 does not include a separate policies and procedures requirement, but, as noted above, provides for board reporting requirements in addition to the chief compliance officer's annual Rule 38a-1 report.

From a practical standpoint, funds will continue to have valuation policies and procedures in place that were adopted prior to Rule 2a-5's compliance date; however, in order to comply with Rule 38a-1 following such date, either the fund (on behalf of the board) or the adviser (as the board's valuation designee) is required to adopt new fair value policies and procedures.

Level 2 Securities. The adopting release states that the definition of "readily available" market quotations is consistent with the definition of a Level 1 input in the fair value hierarchy outlined in GAAP. Thus, Level 2 securities must be fair valued including the securities held by many bond funds. As a practical matter, this means that fixed income securities may continue to be priced using inputs provided by pricing services, subject to the pricing service oversight and other requirements of the new rule. This guidance also means that Level 2 securities may not be eligible for cross-trades under Rule 17a-7 of the Investment Company Act, which requires that a security must have a "readily available" market quotation. The adopting release clarifies that the definition of a "readily available" market quotation applies across the Investment Company Act and the rules thereunder, including Rule 17a-7. The SEC notes, however, consideration of potential revisions to Rule 17a-7 is on the rulemaking agenda.

Recordkeeping. The SEC also adopted Rule 31a-4, a companion recordkeeping rule to Rule 2a-5, that requires funds or advisers (if designated as the valuation designee) to keep appropriate documentation to support fair value determinations for six years.

Rescinded SEC Guidance. In connection with the adoption of Rules 2a-5 and 31a-4, the SEC staff rescinded Accounting Series Releases 113 and 118, which provide guidance on a fund board's role in fair value determinations and certain accounting and audit matters. The adopting release also provides that certain SEC staff no-action and interpretative letters regarding a board's role in the fair value process and other matters covered by the final rules are being withdrawn. Finally, guidance on oversight of pricing services and valuation of thinly traded securities contained in the SEC's Money Market Funds Adopting Release, which was published in 2014, is also superseded. The relevant SEC guidance will be withdrawn effective as of the compliance date noted below.

Effective and Compliance Dates. The new rules will become effective on March 8, 2021, and funds will have until September 8, 2022 to come into compliance.

Sources: Good Faith Determinations of Fair Value, SEC Release IC-34128 (Dec. 3, 2020), available here; SEC Modernizes Framework for Fund Valuation Practices, SEC Press Release 2020-302 (Dec. 3, 2020), available here.

Virtual Meetings of Fund Boards

As discussed in our July 2020 Update, the SEC extended temporary exemptive relief from in-person voting requirements for fund boards through *at least* December 31, 2020. This temporary relief has not yet expired and will terminate on a date that is at least two weeks from the date the SEC staff specifies in a public notice. The Investment Company Act requires that investment advisory agreements, distribution agreements, Rule 12b-1 plans and the selection of an independent registered public accounting firm be approved by the company's board by an in-person vote, and the SEC's exemptive relief provides temporary relief from in-person voting requirements subject to the conditions discussed in our April 2020 Update.

The SEC has also recently granted exemptive relief to certain fund complexes that permits fund directors to approve sub-advisory agreements or material amendments to existing sub-advisory agreements at virtual or telephonic meetings. The exemptive relief provided to Northern Funds, Principal Funds and Blackstone Alternative Investment Funds provides for permanent relief from complying with the in-person meeting requirement under Section 15(c) of the Investment Company Act, rather than the temporary relief described above. Conditions to this exemptive relief include permitting any director the ability to ask that the meeting be held in person.

Sources: Northern Funds, Exemptive Relief, Inv. Co. Act Release No. 34095; 812-15155 (Nov. 13, 2020), available here; Principal Funds, Exemptive Relief, Inv. Co. Act Release No. 33973; 812-15115 (August 19, 2020), available here; Blackstone Alternative Investment Funds, Exemptive Relief, Inv. Co. Act Release No. 33748; 812-15007 (Jan. 21, 2020), available here; and Greg Saitz, Board IQ, "More Boards Get Permission to Vote Remotely on Subadvisers" (Dec. 22, 2020), available by publication.

SEC Adopts Derivatives Risk Management Rule

On October 28, 2020, the SEC adopted Rule 18f-4 under the Investment Company Act and several amendments related to the use of derivatives by open- and closed-end investment companies, ETFs and business development companies (BDCs). The rule will permit a fund to enter into derivatives transactions despite the restrictions under Section 18 of the Investment Company Act, subject to the conditions of Rule 18f-4. Under this new framework, funds using derivatives generally will have to adopt a derivatives risk management program that a derivatives risk manager (DRM) administers and that the fund's board of directors oversees, and comply with an outer limit on fund leverage risk based on value at risk, or "VaR." Funds that use derivatives only in a limited manner will not be subject to these requirements, but they will have to adopt and implement policies and procedures reasonably designed to manage the fund's derivatives risks. The new rule does not include an asset segregation requirement that funds were required to follow in order to cover their derivatives positions under the SEC's previous guidance under Section 18, much of which is being withdrawn. Funds that invest in reverse repurchase agreements or similar financing transactions, however, may choose to comply with asset coverage requirements.

Derivatives Risk Management Program. Rule 18f-4 generally requires that a fund that enters into derivatives transactions (other than a fund that qualifies as a "limited derivatives user" as described below) must adopt and implement a written derivatives risk management program that contains policies and procedures reasonably designed to manage the fund's derivatives risks and segregate the functions associated with the program from the portfolio management of the fund.

Derivatives Transactions. Derivatives transactions include:

- any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar instrument under which a fund is or may be required to make payment or delivery of cash or other assets during the life of the instrument or at maturity or early termination, whether as margin or settlement payment or otherwise;
- any short sale borrowing; and
- reverse repurchase agreements and similar financing transactions, if the fund chooses to treat those transactions as derivatives transactions under the rule.

Derivatives Risk Manager. A DRM who has been approved by the board must administer the program. A fund board does not need to approve the program itself. Boards may request that a fund's adviser carry out due diligence on the appropriate candidate(s) and articulate the qualifications of the candidate(s) that the adviser puts forward to the board. A DRM must be an officer or officers of the fund's adviser (or a committee of such persons). An adviser may include officers of a sub-adviser on a committee and may delegate certain risk management activities to a sub-adviser, subject to the adviser's oversight. For a fund in which a sub-adviser manages the entirety of the fund's portfolio (as opposed to a portion or sleeve), the sub-adviser's officers alone could serve as the fund's DRM, if approved by the fund's board.

The individual(s) serving as the DRM or on a committee must have relevant experience in the management of derivatives risk, and if a single natural person is designated as the DRM, such person may not be a portfolio manager. If multiple officers comprise the DRM, then a majority of those persons cannot be portfolio managers. Notwithstanding the fact that portfolio managers provide important perspective regarding a fund's use of derivatives and will likely have an important role working with the DRM in the design and implementation of the program, the SEC stated its belief that separation of the derivatives risk management function and the portfolio management function creates an important balance. While it may be difficult for smaller funds to segregate these functions due to limited personnel resources, segregation of these functions is important in the SEC's view and such funds may need to hire additional resources in order to effectively implement a program.

The program must include the following elements:

Derivatives Risk Identification and Assessment. The program must identify and assess the fund's derivatives risks, taking into account its derivatives transactions and other investments.

Risk Guidelines. The program must provide for the establishment, maintenance, and enforcement of investment, risk management, or related guidelines that provide for quantitative or otherwise measurable criteria, metrics, or thresholds of the fund's derivatives risks. The guidelines must specify levels of the given criterion, metric, or threshold that the fund does not normally expect to exceed and the measures to be taken if they are exceeded. The rule does not impose specific risk limits for these guidelines, but instead requires a fund to adopt guidelines that provide for quantitative thresholds.

Stress Testing. The program must provide for stress testing to evaluate potential losses to the fund's portfolio in response to extreme but plausible market changes or changes in market risk factors that would have a significant adverse effect on the fund's portfolio, taking into account correlations of market risk factors and resulting payments to derivatives counterparties. The frequency of stress testing must take into account the fund's investment strategy as well as its investments and current market conditions, provided that stress tests must be conducted no less frequently than weekly.

Backtesting. Funds are required to backtest no less frequently than weekly the results of the VaR calculation model used by the fund in connection with the relative or absolute VaR test, as discussed below.

Internal Reporting and Escalation of Material Risks. The program must identify the circumstances under which persons responsible for portfolio management will be informed regarding the operation of the program, including exceedances of guidelines and the results of stress testing. The rule also requires direct communication between the DRM and the fund's board regarding material risks arising from the fund's derivatives transactions.

Periodic Review of Program. The DRM must review the program at least annually to evaluate the effectiveness of the program and to reflect changes in the fund's derivatives risks over time. The periodic review must include a review of the VaR calculation model used by the fund.

Limits on Fund Leverage Risk. A fund must comply with an outer limit on fund leverage risk based on VaR. VaR is an analytic metric used in the financial services industry that estimates an instrument's or portfolio's potential losses over a given time horizon and at a specified confidence level. The outer limit is based on a relative VaR test that compares the fund's VaR to the VaR of a designated reference portfolio. The portfolio could be an index that meets certain requirements or the fund's own securities portfolio (excluding derivatives transactions). The limit is set at 200% of the VaR of the fund's designated reference portfolio, unless the fund is a closed-end company that has issued preferred stock, in which case the VaR must not exceed 250% of the designated reference portfolio. A fund will be required to comply with the relative VaR test unless the DRM reasonably determines that a designated reference portfolio would not provide an appropriate reference portfolio for purposes of the relative VaR test, taking into account the fund's investments, investment objectives, and strategy, in which case the fund would instead be required to comply with an absolute VaR test. Under the absolute VaR test, the VaR of a fund's portfolio cannot exceed 20% (25% for closed-end funds with then-outstanding shares of preferred stock) of the value of the fund's net assets.

Compliance Testing and Remediation. A fund must determine its compliance with the applicable VaR test once each business day, and if the fund exceeds its outer limit, it will have to come back into compliance promptly after such determination, in a manner that is in the best interests of the fund and its shareholders. If the fund is not in compliance within five business days:

- the DRM must provide a written report to the board and explain how and by when the DRM reasonably expects that the fund will come back into compliance;
- the DRM must analyze the circumstances that caused the fund to be out of compliance and update any program elements as appropriate; and
- the DRM must provide a written report to the board within 30 calendar days explaining how the fund came back into compliance.

Board Oversight. On or before the date of implementation of the derivatives program, and at least annually thereafter, the DRM must evaluate the program's effectiveness and provide a written report to the board stating that the fund's program is reasonably designed to manage the fund's derivatives risks and to incorporate the required elements of the program. If the risk manager determines to change the fund's designated reference portfolio, the annual report must also include the basis for such change. At a frequency determined by the board, the DRM must regularly provide written reports to the board regarding the results of the fund's stress testing, backtesting and an analysis of the fund's exceedances of its risk guidelines.

The role of the board under Rule 18f-4 is one of general oversight. Consistent with that obligation, the SEC "expect[s] that directors will exercise their reasonable business judgment in overseeing the program" on behalf of fund shareholders. Boards are expected to receive sufficient information about derivatives risks on a regular basis and request follow-up information when appropriate.

Exception for Funds with Limited Derivatives Investments. Funds that limit their derivatives exposure to 10% of their net assets (excluding currency and interest rate derivatives entered into for hedging and fund borrowings) are exempt from the derivatives risk management program requirement, including the requirement to set a VaR-based limit on fund leverage and the related board oversight and reporting requirements, though they are still required to adopt general policies and procedures to manage derivatives risks. If a fund's derivatives exposure exceeds the 10% limit for more than five business days, the adviser must report to the board, in writing, whether the fund will reduce exposure within 30 days or adopt a derivatives risk management program and comply with the other requirements of Rule 18f-4 as soon as reasonably practicable.

Recordkeeping. A fund must maintain a written record of its policies and procedures that are designed to manage the fund's derivatives risks, in addition to other prescribed records and reports, for a period of at least five years.

Amendments to Reporting Forms. The SEC also amended Forms N-CEN, N-PORT and N-LIQUID (and renamed it Form N-RN), which will now require funds to report whether they have relied on Rule 18f-4 or any of its exceptions; disclose information regarding the fund's derivatives risk management program, including, as applicable, the fund's VaR, designated reference portfolio, and VaR backtesting results; VaR test breaches; and, if the fund is operating as a limited derivatives user, information about the fund's derivatives exposure and the number of business days its derivatives exposure exceeded 10% of its net assets.

Rescinded SEC Guidance. In connection with the adoption of Rule 18f-4, the SEC rescinded its General Statement of Policy (Release 10666), which since 1979 has provided guidance on how funds may engage in certain trading practices in light of Section 18's restrictions. Funds may continue to rely on Release 10666 until the end of the 18-month transition window described below.

Reverse Repurchase Agreements. Under Rule 18f-4, a fund may engage in reverse repurchase agreements (reverse repos) or similar financing transactions if the fund combines the aggregate amount of indebtedness associated with all reverse repos or similar financing transactions when calculating the asset coverage ratio under Section 18. If the fund also borrows from a bank, for example, these senior securities as well as the reverse repurchase agreement would be required to comply with the asset coverage requirements under the Investment Company Act. Alternatively, a fund may enter into these transactions by electing to treat them as derivatives transactions under the rule.

Securities Lending. A fund that invests the proceeds from its securities lending activities in securities (other than cash and cash equivalents) would be engaged in a similar financing transaction and subject to Rule 18f-4.

Effective and Compliance Dates. The rule and related amendments will become effective on February 19, 2021, and funds will have until August 19, 2022 to come into compliance.

Source: Use of Derivatives by Registered Investment Companies and Business Development Companies, Release No. IC-34084 (Oct. 28, 2020), available here.

SEC Adopts New Fund of Funds Rule

On October 7, 2020, the SEC adopted Rule 12d1-4 under the Investment Company Act, which is designed to streamline and enhance the regulatory framework applicable to fund of funds arrangements.

Rule 12d1-4. The new rule permits a fund to acquire shares of another fund in excess of the limits set forth in Section 12(d)(1) without obtaining an exemptive order. Open-end and closed-end funds, BDCs and ETFs all may rely on Rule 12d1-4 as both acquiring and acquired funds. The rule does not permit private funds and unregistered investment companies to rely on the rule as acquiring funds.

Conditions of Rule 12d1-4 include the following:

Control and Voting. The rule generally prohibits an acquiring fund and its "advisory group" (which includes affiliates of the fund and its investment adviser), in the aggregate, from controlling an acquired fund. An acquiring fund and its advisory group must use mirror voting if it holds more than: (i) 25% of an acquired open-end fund due to a decrease in the outstanding securities of the acquired fund or (ii) 10% of a closed-end fund. In circumstances where acquiring funds are the only shareholders of an acquired fund, pass-through voting must be used.

Exception to Control and Voting Requirements. The control and voting conditions do not apply if either: (i) the acquiring fund is in the same group of investment companies as the acquired fund; or (ii) the acquiring fund's sub-adviser or an affiliate is the acquired fund's adviser.

Evaluations and Required Findings. An acquired fund's adviser is required to assess, at minimum, the following factors to make a finding that any concerns regarding undue influence associated with an investment by acquiring funds are reasonably addressed:

- Size of contemplated investments by the acquiring fund and any maximum investment limits;
- Anticipated timing of redemption requests;
- Whether, and under what circumstances, the acquiring fund will provide advance notification of investments and redemptions; and
- Circumstances under which the acquired fund may elect to satisfy redemption requests in kind rather than in cash and the terms of any redemptions in kind.

An acquiring fund's adviser will also be required to make a finding that the acquiring fund's fees and expenses do not duplicate the fees and expenses of the acquired fund, based on the adviser's evaluation of the structure and the fees and expenses associated with investing in the acquired fund.

An adviser to each acquiring or acquired fund must report its evaluations and findings to the fund's board of directors, but the board report does not need to be made prior to investment.

Fund of Funds Investment Agreement. Funds that do not have the same adviser must enter into an agreement prior to the purchase of acquired fund shares in excess of Section 12(d)(1)'s limits. The agreement must include: (i) any material terms necessary for the adviser to make the required findings (described above); (ii) a termination provision permitting the acquiring or acquired fund to terminate the agreement on no more than 60 days' written notice; and (iii) a requirement that the acquired fund provide the acquiring fund with information on the fees and expenses of the acquired fund reasonably requested by the acquiring fund. The adopting release notes that the SEC believes that fund of funds investment agreements are material contracts and as a result they must be filed as an exhibit to each fund's registration statement.

General Prohibition on Complex Structures. Rule 12d1-4 is designed to restrict fund of funds arrangements to two tiers, subject to certain exceptions. The exceptions include: (i) investments that are part of a master-feeder structure; (ii) investments in money market funds in reliance on Rule 12d1-1; and (iii) securities received in connection with a

permitted interfund lending arrangement. In addition to these exceptions, the rule allows an acquired fund to invest up to 10% of its total assets ("10% bucket") in other funds (including private funds) without regard to the purpose of the investment. Investments that are made pursuant to the exceptions enumerated above do not count toward an acquired fund's 10% bucket.

Rescission of Rules, Exemptive Orders, and Staff Guidance. Rule 12d1-2, which permitted funds of affiliated funds relying on Section 12(d)(1)(G) to also invest in unaffiliated funds and make direct investments in securities and money market funds, was rescinded and certain staff no-action letters relating to Section 12(d)(1) were withdrawn. The SEC also rescinded exemptive relief permitting fund of fund arrangements that fall within the scope of Rule 12d1-4 and noted that exemptive orders permitting arrangements outside the scope of Rule 12d1-4 are not rescinded.

Rule 12d1-1. Rule12d1-1 was amended to allow funds that rely on Section 12(d)(1)(G) to invest in money market funds that are not part of the same group of investment companies.

Amendments to Form N-CEN. Form N-CEN will be amended to require funds to report whether they relied on Rule 12d1-4 or Section 12(d)(1)(G) during the applicable reporting period.

Recordkeeping Requirements. Affiliated and unaffiliated acquiring and acquired funds must maintain each fund of funds' investment agreement and other records under the rule for at least five years.

Effective Date and Compliance Dates. Rule 12d1-4 became effective on January 19, 2021, and funds may rely on the rule as of that date. In order to provide funds with a transition period, the compliance date for the amendments to Form N-CEN and the rescission of Rule 12d1-2 and the exemptive orders will be January 19, 2022.

Source: Fund of Funds Arrangements, SEC Release No. IC-34045 (Oct. 7, 2020), available here.

LATEST DEVELOPMENTS: ADVISERS

SEC Adopts Modernized Marketing Rule

On December 22, 2020, the SEC adopted an amended marketing rule for investment advisers that creates a single rule to replace the existing advertising and cash solicitation rules applicable to registered investment advisers. This action reflects a comprehensive revision to rules that were originally adopted over 40 years ago. The amendments to Rule 206(4)-1 under the Advisers Act (the Marketing Rule) do not change the SEC's concerns in adopting the current advertising and cash solicitation rules, which were designed to address the potential harm to investors from misleading advertisements and to provide disclosures about potential conflicts in cash solicitation arrangements. Rather, the amendments are intended to replace outdated rules with a principles-based approach that reflects the continued evolution in technology and advisory practices.

The Marketing Rule will allow investment advisers more flexibility in using performance advertising (including hypothetical and back-tested performance), testimonials and endorsements, subject to restrictions, but will also result in practice changes and new compliance obligations. In order to establish a violation of the new rule, the SEC will only need to establish that an investment adviser acted with negligence.

Defining Advertisement. Under amended Rule 206(4)-1, the definition of "advertisement" includes two prongs: the first relating to traditional advertising practices, and the second relating to traditional solicitation practices (which effectively replaces the current cash solicitation rule).

- The first prong defines an advertisement as any direct or indirect communication an adviser makes, which: (i) offers the adviser's investment advisory services with respect to securities to prospective clients or private fund investors, or (ii) offers new advisory services with respect to securities to current clients or private fund investors.

- This prong generally does not include one-on-one communications (unless the communication involves hypothetical performance not provided in response to an unsolicited investor request or to a private fund investor) and expressly excludes extemporaneous, live oral communications, as well as information contained in a statutory or regulatory notice, filing or other required communication (such as Form ADV Part 2 or Form CRS).
- This revised definition expands the scope of the existing advertising rule to include all offers of investment advisory services by an adviser with respect to securities regardless of how they are disseminated, be it through emails, texts or instant messages, electronic presentations, videos, films, podcasts, digital audio or video files, blogs, billboards and other forms of social media or print media.

▪ The second prong of the definition of advertisement is triggered by any form of compensation that an adviser provides for an endorsement or testimonial. The adopting release notes that compensation for these activities can incentivize a person to provide a positive statement about, solicit an investor for, or refer an investor to, an adviser.

- This prong includes oral and one-on-one communications, but excludes certain information contained in a statutory or regulatory notice, filing or other required communication.
- This revised definition covers both cash and non-cash compensation that the adviser pays directly or indirectly, such as reduced or waived advisory fees, directed brokerage and awards or other prizes.

The adopting release provides examples of what may constitute an advertisement, noting that such determination depends on the facts and circumstances of the advertisement. For example, ordinary communications with existing clients about their accounts, event sponsorships (e.g., a communication noting an event is "brought to you by XYZ Advisers"), or market commentary or general educational materials that do not offer "investment advice" would generally not be considered advertisements. However, if materials that provide general market commentary, for example, also include commentary offering an adviser's advisory services, then that portion of the materials would be considered an advertisement under the Marketing Rule.

General Prohibitions. The Marketing Rule includes the following list of principles-based prohibitions related to advertising that are derived from historic anti-fraud provisions under federal securities laws:

▪ making an untrue statement of a material fact, or omitting to state a material fact necessary in order to make the statement made, in light of the circumstances under which it was made, not misleading;

▪ making a material statement of fact that the adviser does not have a reasonable basis for believing it will be able to substantiate upon demand by the SEC;

▪ including information that would reasonably be likely to cause an untrue or misleading implication or inference to be drawn concerning a material fact relating to the adviser;

▪ discussing any potential benefits to investors or clients in connection with the adviser's services or methods of operation without providing fair and balanced treatment of any material risks or limitations associated with potential benefits;

▪ referencing specific investment advice provided by the adviser where such advice is not presented in a manner that is fair and balanced (this general prohibition replaces the current rule's per se prohibition on past specific recommendations);

▪ including or excluding performance results, or presenting performance time periods, in a manner that is not fair and balanced; or

▪ including information that would otherwise be materially misleading.

The adopting release provides that an adviser should consider the facts and circumstances of each advertisement in applying these prohibitions, including the nature of the audience to which the ad is directed.

Testimonials and Endorsements. The Marketing Rule expands the current advertising framework to permit advisers to include endorsements and testimonials in advertisements, subject to certain disclosure, oversight and disqualification provisions, and also expands the definitions of testimonial and endorsement to include certain solicitation activity. Such testimonials and endorsements are also subject to the general prohibitions described above.

Required Disclosures. The Marketing Rule requires advertisements to clearly and prominently disclose whether the person providing the testimonial or endorsement (i.e., the "promoter") is a client of the adviser and whether the promoter is compensated for such testimonial or endorsement. The final rule also requires certain disclosures regarding material conflicts of interest on the part of the promoter resulting from the adviser's relationship with such person, as well as the material terms of any compensation arrangements with promoters.

Adviser Oversight and Compliance. All testimonials and endorsements (regardless of whether they are compensated) are subject to adviser oversight and compliance, which requires advisers to have a reasonable basis for believing that a testimonial or endorsement complies with the Marketing Rule's requirements. The Marketing Rule also requires written agreements with promoters, unless a promoter is an affiliate of the adviser or receives no or de minimis compensation (i.e., $1,000 or less during the preceding twelve months, or the equivalent value in non-cash compensation). The adopting release also clarifies that advisers should adopt policies and procedures in accordance with Rule 206(4)-7 (the Compliance Rule) of the Advisers Act to ensure compliance with the Marketing Rule, but the Marketing Rule itself does not mandate specific elements of such policies and procedures.

Disqualifications. The Marketing Rule prohibits advisers from compensating promoters for a testimonial or endorsement if the adviser knows or should know that the promoter is an ineligible person. Ineligible persons include, among others, those persons or entities subject to a SEC order prohibiting them from acting in any capacity under the federal securities laws or to prescribed disqualifying events.

Third-Party Ratings. The Marketing Rule prohibits advisers from using third-party ratings in their advertisements, unless an adviser also provides certain disclosures and complies with certain criteria relating to the preparation of such rating or ranking. The use of third-party ratings in an advertisement must also comply with the Marketing Rule's general prohibitions discussed above.

Performance Advertising. In addition to complying with the Marketing Rule's general prohibitions, the Rule also provides that an advertisement cannot:

- include gross performance without also presenting net performance;
- contain performance results, unless the advertisement includes performance results for one-, five- and ten-year periods (as applicable);
- include any statement (express or implied) that the calculation or presentation of performance results has been approved or reviewed by the SEC;
- include related performance, unless all related portfolios are included (except in limited circumstances);
- contain any extracted performance, unless the ad provides, or offers to provide promptly, the performance results of the entire portfolio;
- include any hypothetical performance (which includes model and back-tested performance) unless the adviser adopts and implements policies and procedures designed to ensure hypothetical performance is relevant to the investment objectives and likely financial situation of the intended audience, and provides certain information relating to the hypothetical performance; and
- provide any predecessor performance, unless there is sufficient similarity relating to the personnel and accounts at the predecessor adviser and the personnel and accounts at the advertising adviser.

Amendments to Form ADV and Recordkeeping Rule. The SEC adopted amendments to Form ADV, which will require advisers to provide information regarding their marketing practices in Item 5 of Part 1A. The SEC also adopted amendments to the books and records rule under the Advisers Act in light of the Marketing Rule's adoption.

Withdrawal of No-Action Letters. The adopting release also provides that staff of the Division of Investment Management will withdraw no-action letters and other guidance published by the staff that the staff believes is now covered by the Marketing Rule or no longer applicable. The SEC staff no-action letters that address the current solicitation rule will also be nullified because the SEC is rescinding that rule. The list of withdrawn letters and guidance will be published on the SEC's website.

Transition Period and Compliance Date. The Marketing Rule and corresponding amendments to Form ADV and the books and records rule will be effective 60 days after publication in the Federal Register, and advisers will have 18 months from the effective date to come into compliance.

Sources: Investment Adviser Marketing, SEC Release No. IA-5653 (Dec. 22, 2020), available here; SEC Adopts Modernized Marketing Rule for Investment Advisers, SEC Press Release No. 2020-334 (Dec. 22, 2020), available here.

DOL Issues New Exemption for Investment Advice Fiduciaries

On December 15, 2020, the Department of Labor (DOL) announced its adoption of a new prohibited transaction exemption. This exemption, which was proposed in July and discussed in in our July 2020 Update, allows investment advice fiduciaries, including investment advisers, broker-dealers and banks, to receive compensation, such as commissions, sales loads and 12b-1 fees, for providing fiduciary investment advice. The exemption expands the scope of what constitutes fiduciary investment advice to generally include rollover recommendations. The final exemption includes changes from the proposal, including a requirement that investment advice fiduciaries provide written disclosure to retirement investors of the reasons that a rollover recommendation is in their best interest. The exemption is scheduled to be effective February 16, 2021, after the Biden administration takes office, which means the exemption has an uncertain fate. It is common during a presidential transition for a new administration to suspend any final rules that are not yet effective for the purposes of determining whether the final rule should be implemented, modified or rescinded.

Sources: Prohibited Transaction Exemption 2020-02, Improving Investment Advice for Workers & Retirees (Dec. 18, 2020), available here; News Release, U.S. Department of Labor Announces Exemption to Improve Investment Advice and Enhance Financial Choices for Workers and Retirees (Dec. 15, 2020), available here; ICI Memorandum, DOL Releases Final Class Exemption for Fiduciary Advice (Dec. 18, 2020), available by subscription; Anne Tergesen, Labor Department Finishes Fiduciary Rule for Retirement Plans, Wall Street Journal (Dec. 15, 2020), available by subscription.

Risk Alert Regarding Compliance Programs

OCIE (which recently changed its name to the Division of Examinations) issued a Risk Alert that provides an overview of compliance issues it observed in examinations of SEC-registered advisers relating to Rule 206(4)-7 of the Advisers Act (the Compliance Rule).

The Risk Alert lists six examples of Compliance Rule deficiencies and weaknesses observed by the OCIE:

- inadequate compliance resources, such as CCOs wearing multiple hats and insufficient resources for personnel or technology;
- insufficient authority of CCOs;
- annual review deficiencies;
- failure to implement actions required by written policies and procedures;
- failure to maintain accurate and complete information in policies and procedures; and
- failure to maintain or establish reasonably designed written policies and procedures regarding:
    - portfolio management;
    - marketing;

- trading practices;
- disclosures, such as ADV disclosures and client communications;
- advisory fees and valuation of client assets;
- safeguards for client privacy, including general cybersecurity, data loss prevention and incident response plans;
- required books and records;
- safeguarding of client assets (i.e., custody); and
- business continuity plans.

The risk alert encourages advisers to review their policies and procedures to ensure they accurately reflect the adviser's business.

Source: OCIE Risk Alert: OCIE Observations: Investment Adviser Compliance Programs (Nov. 19, 2020), available here.

COMPLIANCE DATES FOR FINAL RULES

Final Rule	Compliance Date(s)
Optional Internet Availability of Fund Shareholder Reports (Rule 30e-3)	Funds may begin distributing shareholder reports via electronic delivery on January 1, 2021 if they have satisfied the shareholder notification requirements under Rule 30e-3, namely they must have included prominent disclosures on each applicable document (summary prospectus, statutory prospectus and annual and semi-annual shareholder reports) for two full years (or since inception if after January 1, 2019). New funds may rely on the rule immediately.
New Fund of Funds Rule (Rule 12d1-4) and Related Amendments; Rescission of Rule 12d1-2	Rule 12d1-4 became effective on January 19, 2021, but, in order to provide funds with a transition period, the compliance date for the amendments to Form N-CEN and the recission of Rule 12d1-2 and fund of funds exemptive orders is January 19, 2022.
Derivatives Risk Management Rule (Rule 18f-4) and Related Amendments; Rescission of Prior SEC Guidance (Release 10666)	Rule 18f-4 and related amendments to Forms N-CEN, N-PORT and N-LIQUID (to be renamed Form N-RN) will become effective on February 19, 2021, and the compliance date is August 19, 2022. The SEC will rescind Release 10666 and related staff no-action letters and guidance effective August 19, 2022.
Fair Valuation Rules (Rules 2a-5 and 31a-4)	Rules 2a-5 and 31a-4 will become effective on March 8, 2021, and funds will have until September 8, 2022 to come into compliance.
Advertising and Cash Solicitation Rule Amendments (Rules 206(4)-1 and 204-2)	The rule and related amendments are effective 60 days after publication in the Federal Register, and funds will have 18 months from the effective date to come into compliance.