February 3, 2021

Ropes & Gray's Investment Management Update December 2020–January 2021

The following summarizes recent legal developments of note affecting the mutual fund/investment management industry:

SEC No-Action Letter Regarding Funds' Self-Custody of Uncertificated Loan Interests

In a January 13, 2021 no-action letter, the SEC staff provided no-action assurances under Section 17(f) of the 1940 Act and Rule 17f-2 thereunder to funds that proposed to maintain custody of uncertificated Loan Interests (as defined below) pursuant to (i) modified compliance with Rule 17f-2(b)-(e) and (ii) without complying with Rule 17f-2(f) (*i.e.,* multiple verifications annually by an independent auditor).[1]

The SEC staff's no-action assurances were based upon the funds' representations and subject to a number of conditions, described in the incoming letter and summarized below.

Representations by the funds. The funds' investments covered by the no-action letter are interests in corporate loans originated by banks, insurance companies or other financial institutions (the "primary lenders"). For each loan, one or more of the primary lenders or another financial institution administers the loan on behalf of the lending syndicate (the "Administrative Agent"). The terms and conditions of each loan's credit agreement permit the primary lenders to sell interests in the loan ("Loan Interests") to third parties, including the funds. In these transactions, the funds do not receive any (i) certificates or document indicating ownership of a Loan Interest that could be held in the custody of a fund custodian or (ii) documentation that, when endorsed and delivered to another purchaser, could be used by the purchaser to evidence its ownership of a Loan Interest.

Records are typically maintained by an Administrative Agent to identify the owners of the Loan Interests and the principal amount of the original corporate loan attributable to each owner. The funds normally rely on the Administrative Agent to collect their portion of the payments due on the Loan Interests and to remit these payments to the funds' custodian.

Sale of a Loan Interest is a multi-step process that includes (i) settlement coordination under which the seller, the purchasing fund and the Administrative Agent (on behalf of the borrower) coordinate the proposed settlement date and other terms of the transfer, (ii) counter-signature of the Assignment Agreement by the Administrative Agent, (iii) communication of the details of the proposed transaction to the parties for review and confirmation, (iv) transmission of information regarding the funding of the purchase price required to settle the transaction, (v) final verification by parties prior to funding and (vi) wire transfer of the purchase price and recordation of the purchasing fund's interest on the ownership records maintained by the Administrative Agent. This multi-step process normally is completed electronically, using an electronic trading and settlement platform for Loan Interests. Relevant documentation for each loan (the "Loan Documents") is typically executed and exchanged electronically, and there are usually no manually executed documents involved in the sale and transfer of Loan Interests.

The funds' existing practice is to maintain the Loan Documents with the funds' custodian. Under a separate, sealed-envelope safekeeping agreement with their custodian, the custodian had agreed to provide for the safekeeping of certain documents, including bank debt agreements, in a secure and access-controlled environment. However, the custodian has

[1] In pertinent part, Rule 17f-2(f) provides that a fund's securities and similar investments must be "verified by actual examination by an independent public accountant retained by the investment company at least three times during each fiscal year, at least two of which shall be chosen by such accountant without prior notice to such company."

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no responsibility to verify the contents of the sealed envelopes or to reconcile the contents of the sealed envelopes (including the bank debt agreements) with the funds' books and records.

Based on the number and frequency of transactions of Loan Interests, and the frequency of refinancings and pay-downs of the underlying loans, the funds maintained that it had become extremely burdensome to maintain copies of the Loan Documents and amendments with the funds' custodian. Moreover, the funds stated that custodians have become reluctant to provide safekeeping services for paper documents, especially in view of the loss of securities certificates and other transaction documentation maintained at the DTC's vault from flooding caused by Hurricane Sandy. Therefore, the funds proposed to end the custody practices described above, such that Loan Documents will no longer be delivered to the funds' custodian for safekeeping. As a consequence, the funds could be deemed to have self-custody of the Loan Interests, thereby requiring the funds to comply with the self-custody requirements of Rule 17f-2. The funds represented that complying with Rule 17f-2 would impose unnecessary burdens with respect to the Loan Interests.

The No-Action Letter. Based on the funds' representations, the SEC staff provided no-action assurances under Section 17(f) of the 1940 Act and paragraphs (b)-(f) of Rule 17f-2, provided the funds comply with the following conditions concerning the Loan Interests:

- Only a limited number of authorized personnel of the funds would provide instructions to the funds' custodian and the Administrative Agents concerning the Loan Interests.
- Passwords or other appropriate security procedures would be used to ensure that only properly authorized persons can transmit such instructions.
- The funds would reconcile settled Loan Interests to the records of Administrative Agents at least monthly. The reconciliation would be performed by portfolio accounting, investment operations personnel or the funds' accounting agent, and not by funds adviser's portfolio management personnel. The funds also will review interest payments for accuracy. This verification process would also supplement the monthly reconciliation because a loan's principal amount is a component of the interest calculation and some interest payments are paid on dates other than month-end.
- Loan Interests would be titled or recorded by each Administrative Agent in the name of a fund and not in the name of adviser.
- Neither the funds nor their adviser would be affiliated with the Administrative Agents for the Loan Interests.
- The funds would adopt policies and procedures reasonably designed to prevent violation of the conditions in the preceding bullet points, and such policies and procedures would be part of the fund's compliance program under Rule 38a-1 under the 1940 Act.

In addition, although not stated as an express condition, the no-action letter stated that the no-action position relied particularly on the funds' representations that the funds are complying with audit requirements consisting of: (i) each fund remaining subject to an annual audit during which the independent public accountant confirms all of the fund's investments, including its investments in Loan Interests, and reconciles the Loan Interests to the fund's account records and (ii) the independent auditor relying on controls testing as reported in the Service Organization Controls Report ("SOC 1") on the fund adviser's fund accounting system and controls around trade authorization, trade confirmation, position reconciliation, cost roll-forward and the systematic calculation of realized gains and losses.

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REGULATORY PRIORITIES CORNER

The following brief updates exemplify trends and areas of current focus of relevant regulatory authorities:

Regulatory Freeze Memorandum

On January 20, 2020, Ronald Klain, President Biden's Chief of Staff, issued a memorandum addressed to the heads of executive departments and agencies regarding a regulatory freeze (the "Regulatory Freeze Memo") and requesting the heads freeze new and pending regulations until the Biden administration's appointees are given the opportunity to review them.

The Regulatory Freeze Memo does not apply directly to the SEC because it is considered an independent agency. President Biden has nominated Gary Gensler to serve as 33rd chair of the SEC and, if Mr. Gensler is confirmed by the Senate, it is possible that the SEC could voluntarily agree to follow the Regulatory Freeze Memo.

- With respect to regulations that have not been published in the *Federal Register*, the Regulatory Freeze Memo requests departments and agencies to withdraw the regulations from publication until they can be reviewed by the relevant Biden administration head. As of the date of this Update, the amendments to Rule 206(4)-1 under the Advisers Act (the "Marketing Rule"), adopted by the SEC on December 22, 2020, have not appeared in the *Federal Register*.

- With respect to regulations that have been published in the *Federal Register* but have not taken effect, the Regulatory Freeze Memo requests departments and agencies to consider postponing the regulations' effective dates during a 60-day period ending March 22, 2021. For regulations postponed in this manner, the Regulatory Freeze Memo requests departments and agencies to consider opening a 30-day comment period to allow interested parties to provide comments about issues of fact, law and policy raised by the regulations, and to consider pending petitions for reconsideration involving such regulations. Rule 18f-4 under the 1940 Act (funds' use of derivatives)[2] and Rules 2a-5 and 31a-4 (determinations of fair value)[3] fall within this group. Notably, Rule 18f-4 was adopted in a 3-2 vote, with Democratic Commissioners Lee and Crenshaw dissenting.

ROPES & GRAY ALERTS AND PODCASTS SINCE OUR OCTOBER-NOVEMBER UPDATE

Podcast: Operating Under the ETF Rule: How Are Things Going in the Early Days?
February 1, 2021
In this episode, which is the fourth in our podcast series focused on ETF issues, Ropes & Gray attorneys Paulita Pike and Ed Baer discussed some of the compliance and board reporting implications of the ETF Rule.

Podcast: 2020 Secondary Market in Review
January 25, 2021
In this Ropes & Gray podcast, asset management partners Isabel Dische, Adam Dobson, Chune Loong Lum and Vincent Ip, and tax partner Dan Kolb shared key trends and developments from the 2020 secondaries market and what secondary buyers, sellers and fund sponsors can expect in 2021.

Whitepaper: Converting Mutual Funds Into ETFs
January 11, 2021
In our most recent podcast on converting a mutual fund to an ETF, we briefly discussed the related legal and operational

[2] *See* Ropes & Gray's November 6, 2020 Client Alert.
[3] *See* Ropes & Gray's December 9, 2020 Client Alert.

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challenges in the conversion. In this updated whitepaper, we delved deeper into the key considerations and challenges in converting a mutual fund into an exchange-traded-fund.

The New Year Brings New Obligations for Exempt and Registered CPOs
January 8, 2021
In 2021, asset managers who are registered or exempt from registration with the U.S. Commodity Futures Trading Commission (the "CFTC") as commodity pool operators ("CPOs") will face a variety of new regulatory obligations. As discussed in this Alert, the CFTC and National Futures Association have, in recent years, amended rules and filing requirements that either have compliance dates in early 2021 or took effect in 2020 but will be encountered by the majority of asset managers for the first time in the new year.

Podcast: COVID-19: End of Life Fund Issues
January 6, 2021
In this Ropes & Gray podcast, asset management partner Jason Kolman and counsel Steve Zaorski discussed certain challenges facing funds reaching the end of their terms, which have intensified in light of COVID-19-related disruptions.

Podcast: Mutual Fund to ETF Conversion
January 5, 2021
In this third episode of our ETF podcast series (recorded on December 20, 2020), Ropes & Gray asset management attorneys Jeremy Smith, Brian McCabe and Ed Baer discussed converting an existing mutual fund into an ETF and the related legal and operational issues.

Podcast: 2020 in the Rearview Mirror (almost): Current Topics and Trends in Debt Documentation
December 21, 2020
In this Ropes & Gray podcast, capital solutions and finance partners Joanne De Silva, Alyson Gal and Leonard Klingbaum, counsel Milap Patel and associate Rob Bennett, discussed topics and trends in debt documentation over the course of 2020. The discussion included a reflection on the challenges faced and strategies implemented as documentation provisions performed under enormous stresses as a result of the global pandemic. Topics discussed include MAE conditionality, financial covenant definitions, value and priority shifting financings in the context of restructurings and general liquidity transactions and key terms under negotiation.

Podcast: ESG: Integrating EU and DOL Requirements
December 16, 2020
In this Ropes & Gray podcast, asset management partner Eve Ellis and ERISA & benefits partner Josh Lichtenstein discussed the recent DOL rule on ESG investing, and how managers should think about integrating these new DOL rules alongside similar, but sometimes competing, rules that have come out in the EU.

The DOL Finalizes Regulation Imposing New Obligations for Plan Sponsors and Asset Managers in Connection with Proxy Voting and Other Exercises of Shareholder Rights by ERISA Plans
December 16, 2020
On December 11, 2020, the U.S. Department of Labor (the "DOL") adopted a final rule amending the investment duties regulation under ERISA to address how plan fiduciaries should exercise shareholder rights, including proxy voting. The DOL indicated that it adopted this rule to address the use by plan fiduciaries of non-pecuniary factors in proxy voting decisions as well as what it has described as a "misconception" among plan fiduciaries that they must generally always vote proxies, even when doing so does not result in a benefit to the plan. Together with the ESG rule the agency finalized at the end of October (see our Alert here), this latest rulemaking reinforces the principle that financial factors impacting plans and their participants and beneficiaries should be the only considerations driving fiduciary decision-making.

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Podcast: Fund-of-Funds Final Rule & Its Impact on ETFs
December 15, 2020
In this second episode of our ETF podcast series, Ropes & Gray asset management attorneys Jeremy Smith, Brian McCabe, and Ed Baer discussed the impact of the fund-of-funds rule on ETFs.

Podcast: Recent FCA Statement on GDPR Compliance
December 14, 2020
In this Ropes & Gray podcast, asset management partner Eve Ellis and data, privacy and cybersecurity partner Rohan Massey discussed a recent press release from the FCA, the UK's financial services regulator, in relation to the handling of client data.

Podcast: Rep and Warranty Insurance in the Context of Fund Recapitalizations: Considerations for Both Fund Sponsors and Investors
December 10, 2020
In this Ropes & Gray podcast, asset management partners Isabel Dische and Adam Dobson, and litigation & enforcement counsel Steve Kaye discussed the use of rep and warranty insurance in fund recapitalization transactions and why its use in the fund recap context has been less common than in other types of M&A transactions. They also shared recent developments in the types of coverage available that may make rep and warranty insurance more interesting to fund sponsors and secondary buyers.

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