Investment Management Regulatory Update

February 25, 2021

COVID-19 Update

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

Industry Update

SEC Issues No-Action Relief under Section 17(f) of Investment Company Act and Rule 17f-2

On January 12, 2021, the Securities and Exchange Commission ("**SEC**") staff provided no-action relief to certain registered management investment companies and series thereof (collectively, the "**Funds**") and their directors or officers, if such Funds act as self-custodians that maintain certain loan interests (i) without strict compliance with paragraphs (b) - (e) of rule 17f-2 under the Investment Company Act of 1940, as amended ("**Investment Company Act**") and (ii) do not comply with paragraph (f) of rule 17f-2.

The specific loans at issue in the no-action letter were term or delayed draw corporate loans ("**Loans**") that were originated, negotiated and structured by one or more primary lenders (i.e., banks, insurance companies or other financial institutions). The primary lenders would sell interests in a Loan ("**Loan Interests**") to third parties, such as the Funds. The Loan Interests were uncertificated, such that there was no documentation evidencing an ownership interest that could be custodied with a Fund's custodian or, that if endorsed and delivered to a subsequent purchaser or other third party, could be used by that party to evidence its own right to the Loan Interest. Furthermore, the Loan Interests were not transferred to a Fund until a multi-step settlement process has been completed, and various documents ("**Loan Documents**") had to be executed in connection with the settlement process. Possession of the Loan Documents themselves was of no value to a purchaser or other purported transferee of a Fund's Loan Interests, rather the Loan Interests were reflected on the records of the borrower under the Loan, which was typically maintained by an administrative agent, for the purpose of identifying the owners of all Loan Interests and the principal amount of the Loan attributable to each.

The Funds' previous practice was to provide the Loan Documents to their custodians for safekeeping under Section 17(f), which posed a number of practical pitfalls that made the custodians reluctant to custody them. Accordingly, the Funds proposed to cease such practice and sought no-action relief to be permitted to self-custody the Loan Documents without complying with certain provisions of rule 17f-2, subject to certain conditions including:

- Only a limited number of the Fund's authorized personnel would be permitted to provide instructions to the Fund's 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, with such reconciliations to be performed by portfolio accounting, investment operations personnel or the funds' accounting agent (not by a Fund's investment adviser's portfolio management personnel) and would be subject to a verification process.
- Loan Interests would be titled or recorded by each administrative agent in the name of a Fund (and not in the name of Fund's investment adviser).
- Neither the Funds nor their investment adviser(s) 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 aforementioned conditions, and such policies and procedures would be part of the Fund's compliance program under Rule 38a-1 under the Investment Company Act.

Moreover, while not included as an express condition to the relief, the SEC staff noted they were granting relief in part because of the Funds' representations that the Funds would comply with certain audit requirements, including being subject to an annual audit during which an independent public accountant will verify all of the investments of each Fund (including its investments in the Loan Interests) and reconcile the Loan Interests to the Fund's account records.

- **See a copy of the no-action letter**

SEC Requests Comments on Potential Money Market Fund Reforms

There is a broad consensus that the money market fund ("**MMF**") reforms adopted in the wake of the 2008 crisis have not fully achieved their intended aims. Indeed, a report by the President's Working Group on Financial Markets released in December 2020 (the "**Report**") concluded that, notwithstanding reforms adopted by the SEC in 2010 and 2014, "more work is needed to reduce the risk that structural vulnerabilities in prime and tax-exempt MMFs will lead to or exacerbate stresses in short-term funding markets."

On February 4, 2021, the SEC requested comment on the Report, including with respect to (1) the effectiveness of previously enacted MMF reforms and (2) the effectiveness of implementing policy measures described in the Report, either in addition to, or a replacement for, previously enacted reforms. The SEC's request for comment is an important step in the MMF reform process, but – as the SEC itself acknowledges – MMF reform is likely to require coordinated action by several regulatory agencies, and perhaps the private sector. Davis Polk has published a **Client Memorandum** discussing the SEC's request.

Acting Chair Allison Herren Lee Issues Statements on Empowering Enforcement and Contingent Settlement Offers Involving Waivers

On February 9, 2021, SEC Acting Chair Allison Herren Lee issued a public **statement** indicating that she had re-authorized senior officers in the Division of Enforcement to approve the issuance of formal orders of investigation, effectively allowing such officers to subpoena documents and take sworn testimony. "Returning this authority to the division's experienced senior officers, who have a proven track record of

executing it prudently, helps to ensure that investigative staff can work effectively to protect investors in an era when the pace of fraud – like the pace of markets themselves – is ever more rapid," Lee said.

Parties considering whether to settle an SEC enforcement investigation or criminal proceeding have a reasonable expectation that they will know the likely consequences of a settlement. This includes whether they can expect to receive a waiver from certain statutory disqualifications. However, on February 11, 2021, the Acting Chair Allison Herren Lee announced that the Division of Enforcement will not recommend any settlement offer that is conditioned on the settling party receiving a waiver. If this statement reduces transparency between SEC staff and parties negotiating a possible settlement, the result likely will be a more difficult and protracted process for both sides as it becomes difficult for settling parties to make informed decisions about the full implications of a resolution. Davis Polk has published a **Client Memorandum** discussing the implications of the Acting Chair's statement.

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

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