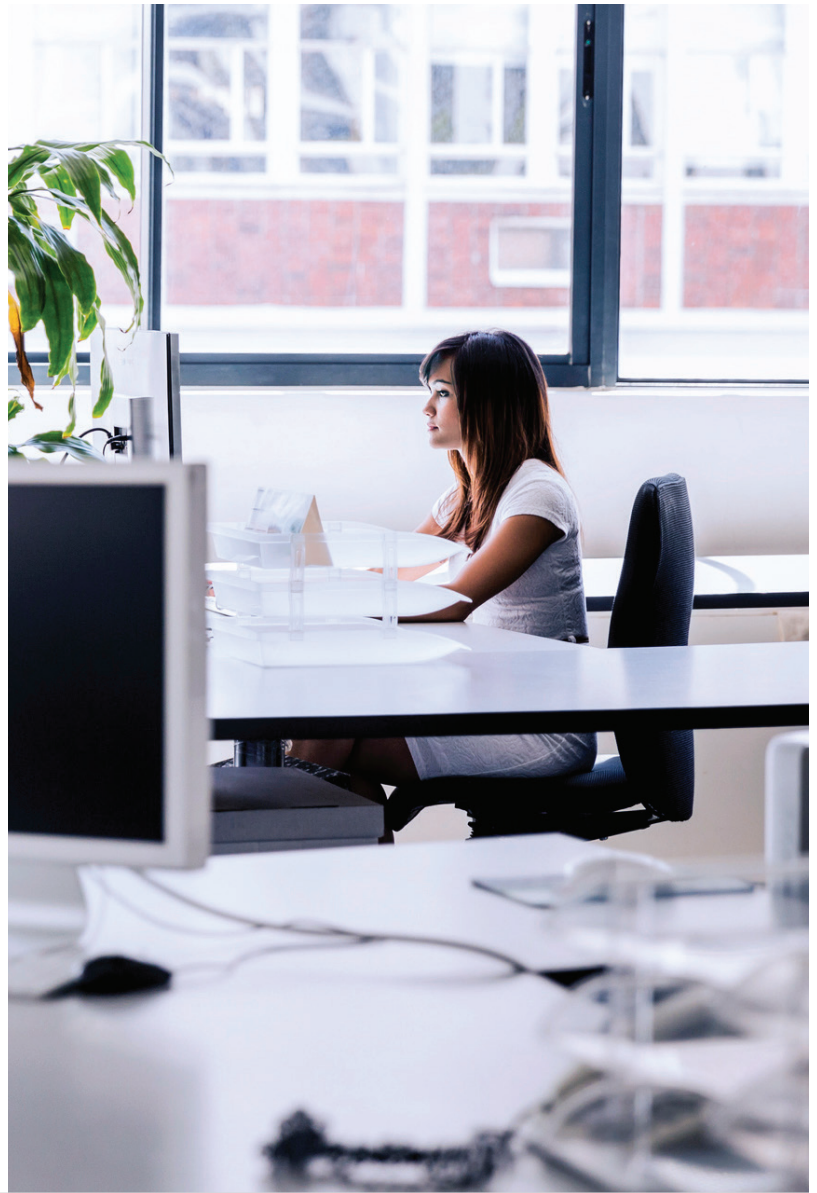


U.S. Bank Regulatory Outlook Report

2022 Edition



*Keeping you informed on topical regulatory matters in the U.S.
and Europe.*

SEC proposes shortened securities transaction settlement cycle

On February 9, 2022, the Securities and Exchange Commission (SEC) proposed to shorten the standard settlement cycle for securities transactions from two business days after the trade date (T+2) to one business day after the trade date (T+1), beginning on March 31, 2024: <https://www.sec.gov/rules/proposed/2022/34-94196.pdf>.

The proposed change is designed to reduce the credit, market and liquidity risks in securities transactions, promote investor protection and increase operational efficiency.

Key change

The proposal would:

- Shorten the standard settlement cycle to T+1 for most broker-dealer transactions.
- Eliminate the separate T+4 settlement cycle for certain firm commitment offerings.
- Improve the processing of institutional trades by requiring broker-dealers and their institutional customers to agree to allocate, confirm and affirm the trade details by the end of the trade date (T).
- Facilitate straight-through processing by proposing new requirements applicable to clearing agencies that are central matching service providers (CMSPs).

The SEC is also “actively assessing” a future move to a same-day standard settlement cycle (T+0), though currently such an initiative is not being proposed.

Cross-industry efforts

The Depository Trust & Clearing Corporation (DTCC) has been leading the industry to accelerate the settlement cycle in collaboration with the Securities Industry and Financial Markets Association (SIFMA), the Investment Company Institute (ICI) and the Industry Steering Group formed by market participants. Information from the industry, including a roadmap setting out the technical requirements for shortening the settlement cycle to T+1, can be found via the following DTCC link: <https://www.dtcc.com/ust1>.

Our role

U.S. Bank is actively monitoring this development and is engaging with industry working groups and the DTCC on the related changes in an effort to assess the required product updates impacting both our customers and internal processes.

SEC proposes cybersecurity risk management rules for investment advisers, registered investment companies and business development companies



On February 9, 2022, the Securities and Exchange Commission (SEC) proposed new rules to require registered investment advisers and investment companies to adopt written cybersecurity policies and procedures reasonably designed to address cybersecurity risks: <https://www.sec.gov/rules/proposed/2022/33-11028.pdf>.

The proposal aims to enhance cybersecurity risk management and improve cybersecurity resilience for investment advisers and registered funds through the adoption of a comprehensive set of requirements that address cybersecurity risk directly.

SEC proposes cybersecurity risk management rules for investment advisers, registered investment companies and business development companies

continued

Key change

The proposal would:

- Require advisers and funds to implement written policies and procedures to reasonably address cybersecurity risks, which are tailored to the business operations, complexity and cyber risk of the adviser/fund. Advisers and registered funds would be required to periodically assess, categorize, prioritize and draft written documentation of cybersecurity risks that affect their information systems, including risks arising from service providers (e.g., order management systems used to automate trading or cloud service providers for maintaining books and records) and to have measures to detect, respond to and recover from a cybersecurity incident.
- Require the board of a registered fund to provide initial approval of the fund's cybersecurity policies and procedures and to review a written report on cybersecurity incidents and material changes to the fund's cybersecurity policies and procedures at least annually.
- Require advisers to report significant cybersecurity incidents to the Commission within 48 hours after an adviser has a reasonable basis to conclude that a significant cybersecurity incident has occurred or is occurring.
- Enhance adviser and fund disclosures related to cybersecurity risks and incidents; funds would be required to submit information using a structured data language.
- Require advisers and funds to maintain, make and retain certain cybersecurity-related books and records.

Looking ahead

The proposed rule directly impacts our clients who are registered advisers and registered funds. U.S. Bank Global Fund Services already provides customers with due diligence presentations, materials and webinars on our cybersecurity risks and controls. We are also reviewing the proposal for any enhanced materials on U.S. Bank Global Fund Services' information security practices in support of customers meeting their compliance obligations with a finalized rule.

Executive Order on Responsible Development of Digital Asset Technology



On March 9, 2022, President Biden issued an executive order (EO) on ensuring responsible development of digital assets. The EO lays out a strategy for national policy on digital assets with six principal objectives:

- Consumer/investor protection
- Financial stability and the mitigation of systemic risk in connection with digital assets
- Mitigation of illicit finance and national security risks
- Promotion of U.S. economic competitiveness and leadership in the global financial system
- Equitable access to financial services
- Support for responsible innovation

The EO establishes a whole-of-government strategy — with significant roles for the State Department, Department of Homeland Security, Director of National Intelligence, and Commerce Department, as well as the Treasury Department and financial regulators — for advancing these priorities.

Executive Order on Responsible Development of Digital Asset Technology

continued

Certain agencies will be required to produce reports or frameworks on topics related to these six objectives over the next six to 12 months. Among other things, the EO highlights and calls for reports on:

- **Central bank digital currencies (CBDCs):** The EO calls for the Treasury Department to issue a report on the future of money and payment systems that addresses several topics, including the implications of CBDCs for the U.S. financial system and democracy. It encourages U.S. participation in “multi-country conversations and pilot projects involving CBDCs” and requires a report on the technical infrastructure, capacity and expertise that would be necessary to launch a CBDC in the United States. The EO directs the Attorney General to provide President Biden with an assessment of any legislative changes that would be necessary to issue a U.S. CBDC, along with a legislative proposal.
- **National security and illicit finance risk:** The EO highlights the national security implications of digital assets, whether CBDCs or private sector stablecoins or cryptocurrencies, and directs agencies across the government to report on risks, plans for coordinated action to mitigate digital asset-related illicit finance and national security risks and law enforcement gaps.
- **Economic and technological competitiveness:** The EO emphasizes the importance of reinforcing U.S. economic and technological competitiveness and leadership, including through responsible development of digital asset technologies and payments innovations. Among other things, the EO directs the Department of Commerce to establish a framework for enhancing U.S. economic competitiveness in and use of digital asset technologies.
- **Energy and climate policy impact:** The EO calls for the Director of the Office of Science and Technology Policy, in consultation with other agencies, to report to the president on the connections between distributed ledger technology and short, medium and long-term economic and energy transitions, as well as the environmental impact of these technologies and their implications for efforts to combat climate change.

The EO is an important step towards developing policy recommendations that will guide the ongoing development of digital assets and encourage regulators to ensure crypto oversight and investor protection.

IOSCO publishes its Consultation Report on Exchange Traded Funds on April 6, 2022

The Consultation Paper (CP) supplements the IOSCO 2013 ETF Principles. The proposed 11 good practices are divided into the following categories: effective product structuring, disclosures, liquidity provisions and volatility control mechanisms. We will focus on the key Good Practices (GP) of note.

Key changes and considerations

Effective product structuring

- **GP 1:** Regulators are encouraged to consider requirements regarding the transparency of an ETF's portfolio and/or other appropriate information provided to market participants to facilitate effective arbitrage.

It is significant to note that the IOSCO's CP does not require full portfolio transparency, which is a marked difference from the Central Bank of Ireland (CBI's) approach. This would be a welcome practical change if adopted by the CBI and would align the Irish market with other jurisdictions.

- **GP 2:** Responsible entities are encouraged to:
 - (i) Conduct due diligence on Authorised Participants (APs) and Market Makers (MMs) when onboarding them to the ETF, with a view towards having those providers that can facilitate an effective arbitrage mechanism and provide liquidity.
 - (ii) Conduct ongoing monitoring on APs and MMs for the ETF regarding, amongst others, the functioning of the arbitrage mechanism and liquidity provision.
 - (iii) Avoid exclusive arrangements with APs and MMs if they may unduly impact the effectiveness of the arbitrage mechanism.

The expectation that UCITS ETFs are obliged to carry out due diligence on APs and MMs at the time of onboarding and have mechanisms in place that allow for ongoing monitoring and due diligence to take place is worth noting. Responsible parties should review their due diligence process and practices and enhance if required.



Disclosures

- **GP 3:** ETFs, in particular those that invest in more complex or novel asset classes or use more complex investment strategies, encourage regulators to consider appropriate requirements for the adequacy and appropriateness of the disclosures regarding ETF-specific aspects. This includes whether certain disclosures are presented in an understandable manner and whether they address the nature of risks associated with the ETFs' strategies.
- **GP 4:** Regulators are encouraged to consider appropriate requirements for the disclosures of fees and expenses for investing in ETFs (including secondary market trading costs) in a way that allows investors to make informed decisions about whether they wish to invest in an ETF and thereby accept a particular level of costs.
- **GP 5:** Regulators and responsible entities are encouraged to consider appropriate disclosure requirements or disclosures to help investors to clearly differentiate ETFs from other ETPs/CIS, as well as appropriate disclosure for index based and non-index-based ETFs.

Investor protection and transparency for investors are key so that all investors are fully aware of the strategies and risks of the funds that they are investing in. Fully understanding the costs involved in investing in ETF funds and products, especially those ETFs traded on secondary markets, is crucial for investors. It is important to note that both offering documentation and websites should be enhanced to include the appropriate information.



Liquidity provisions

- **GP 6:** Regulators and/or trading venues, where applicable, are encouraged to monitor secondary market trading and market making activities of ETFs and have rules governing the orderly trading of ETF shares.

The CP calls out the importance of ETF management companies having mechanisms and processes in place if market makers run into liquidity issues.

Volatility control mechanisms

- **GP 7:** Regulators and/or trading venues, where applicable, are encouraged to appropriately calibrate volatility control mechanisms (VCMs) applicable to ETFs, considering factors including their liquidity profile and volatility profile. Where an ETF is listed or traded on a number of trading venues, those trading venues are encouraged to consider communicating with one another as appropriate when VCMs are triggered.

IOSCO asks that trading venues communicate with each other in respect of volatility control mechanisms and that VCMs are reviewed for appropriateness and effectiveness and encourage consistency among trading venues.



Looking ahead

The consultation is open until July 6, 2022, and subsequently, IOSCO will issue a final good practices report. It's unlikely that there will be much change when the final report is issued.

Due diligence process for APs and MMs should be reviewed and enhanced if deemed necessary. Controls and processes should be reviewed and enhanced to ensure there are appropriate liquidity and arbitrage mechanisms in place. It is interesting to note the divergence of approach in respect of the transparency of portfolio between IOSCO and the CBI and if IOSCO's approach will be documented in the next reiteration of the ESMA Guidelines on ETFs and other UCITS issues. It is also interesting to note that IOSCO questions the eligibility and appropriateness of certain assets for UCITS ETFs.

Our role

U.S. Bank Europe has reviewed the Consultation Paper and will be keeping close to any further updates as we expand our U.S. ETF offering into Europe to service UCITS ETFs. It is an exciting time for the Irish U.S. Bank team as we aim to service our first ETF product later this year and working closely with our colleagues in the U.S. to deliver a seamless experience for our clients.

The CBI issued Cross-Industry Guidance on Outsourcing in December 2021. The intention is that this guidance will supplement existing and future legislation regulations and guidelines including the EBA Guidelines. The guidance will apply in a proportionate manner to the fund service providers associated with the operation of the fund and not to the investment fund itself.

Key change and considerations

- The guidance applies to outsourcing arrangements.
- It is expected that the firms evidence their rationale for determining if an arrangement is critical or important. The methodology of this assessment should be documented in the outsourcing policy and should include any relevant definitions. The outsourcing policy should be approved by the board or equivalent committee as the board and senior management are ultimately responsible for these outsourced arrangements.
- One of the key changes is that the CBI guidance does not see 'delegation' and 'outsourcing' as two distinct activities, rather, they view these activities as interchangeable. This has a wider impact for the Irish industry, in particular for depositary services. The depositary of an Irish regulated fund will delegate their asset safekeeping duties to a global sub-custodian (often within their organization) and dependent on client requirements, may appoint a prime broker as a sub-custodian into the custodial network. These arrangements would be considered in the past to be delegation as set out in the UCITS V and AIFM Directives. With the issuance of the CBI Guidelines, these arrangements are now considered to be outsourcing arrangements.
- The guidance has stipulated that intragroup outsourced arrangements should be risk assessed in the same manner as external outsourcing arrangements.
- Firms should review concentration risk, offshore risk, sub-outsourcing risk and sensitive data risk as part of their outsourcing risk framework. Firms are expected to have a defined exit strategy and a business continuity plan in place for critical and important outsourced arrangements.

Central Bank of Ireland issues Cross-Industry Guidance on Outsourcing

continued

Looking ahead

The CBI expects that critical or important outsourced arrangements and any material changes are notified to the CBI. Firms are expected to update their outsourcing register.

Our role

Firms are working to ensure their processes, procedures, governance, and risk framework are compatible and adhere to the CBI Cross-Industry Outsourcing Guidance. Industry groups are reviewing the guidance and working to ensure there is a uniform approach to the guidance as much as possible across fund administrators, depositories and management companies. U.S. Bank/Elavon are involved and participating in industry and Irish Funds working groups and are actively engaging with our counterparts in forging a way forward to meet the Irish Regulator's expectations.

Contact us

*For questions or concerns, please
contact a member of our team:*

Lili Popova-Flashenburg

Vice President, Global Network Management Regulatory Review Manager
(United States)

Phone: +8573382167

Email: lili.popovaflashenburg@usbank.com

Caroline Geraghty

Vice President, Senior Depository Manager - Europe

Phone: +353873205938

Email: caroline.geraghty@usbank.com

This regulatory outlook can be found on pivotmarketwatch.usbank.com.

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