Investment Services Regulatory Update

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Monthly Version

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PROPOSED RULES

FINRA Seeks Comment on Liquidity Risk Management Rule for Certain Member Firms

On June 12, 2023, FINRA released Regulatory Notice 23-11, seeking comment on a potential liquidity risk management rule for certain member firms. The proposal is very much in its early stages, with the FINRA staff seeking comment before FINRA's Board of Governors would authorize FINRA to make a formal rule filing with the SEC. Rule 4610, as proposed by the FINRA staff, would protect customers and other creditors in the event a broker-dealer fails and would work in conjunction with similar rules such as the Net Capital Rule and the Customer Protection Rule. Proposed Rule 4610 uniquely targets the issue of liquidity risk, or the risk that a firm will not have sufficient cash or other liquid assets to meet its obligations as they arise. The staff proposal cites recent events such as market volatility and stress caused by the onset of the COVID-19 pandemic in 2020 and trading in certain "meme stocks" in 2021 as potential reasons for a liquidity risk management rule. During those periods, some firms became subject to collateral calls from clearing corporations and experienced other unforeseen needs for liquid assets due to extreme market volatility and other factors.

As proposed by the FINRA staff, Rule 4610 would apply to (1) members that carry customer accounts and clear transactions and (2) members that carry the customer accounts of other broker-dealers. The rule would specifically require certain member firms to maintain a liquidity risk management program, including written policies and procedures reasonably designed to assess, manage and periodically review the risks to a member's liquidity. The program would require a member firm both to conduct liquidity stress testing and to maintain a contingency funding plan.

In addition, Rule 4610 would require certain member firms at all times to maintain sufficient liquidity on a current basis. That is, firms would need to have available cash and other liquid assets sufficient to meet their funding obligations as they come due. The staff-proposed rule includes eight conditions that, if even one occurs, would create a rebuttable presumption that the member is not sufficiently liquid. The conditions generally focus on a firm's current borrowings and borrowing ability, such as reductions in credit lines, reduced funding from securities financing arrangements or increased reliance on potentially available funds in the member's Rule 15c3-3 customer reserve account. If any of the eight triggering conditions were to occur, FINRA could restrict or suspend the member's business, unless the member can rebut the presumption that it does not have sufficient current liquidity or it takes corrective action to bolster its liquidity.

Comments on the staff proposal are due by August 11, 2023.

FINRA Regulatory Notice 23-11 is available here.

GUIDANCE AND OTHER DEVELOPMENTS

SEC Allows Expiration of MiFID II No-Action Relief

On July 3, 2023, the SEC staff's no-action relief expired, which had previously permitted broker-dealers to receive separate payments for research without being subjected to investment adviser registration. The SEC staff initially took its no-action position in October 2017 to assist U.S. firms wrestling with the European Union's then-approaching Markets in Financial Instruments Directive (MiFID II). MiFID II introduced new restrictions designed to cause investment managers to "unbundle" the expense of research from the expense of trade execution. The SEC's Division of Investment Management later extended the no-action position until July 3, 2023. Nearly a year ago, William Birdthistle, Director of the SEC's Division of Investment Management, announced that the no-action relief would not be renewed, stating it was a temporary position and not a permanent solution.

Currently, under the safe harbor established by Section 28(e) of the Exchange Act, an investment manager may use its clients' funds (i.e., "soft dollars") to pay for brokerage and research services through a "bundled"

payment. MiFID II, among other things, prohibits investment managers from receiving or retaining any inducements for conducting business, including "research," as defined under the directive, unless the investment manager pays for such research from (1) its own funds (i.e., "hard dollars"), (2) a separate research payment account (RPA), funded with its clients' money or (3) from a combination of the two.

MiFID II's research unbundling rules introduced heightened concerns for U.S. broker-dealers because receiving MiFID II-compliant direct payments for research from EU investment managers would constitute "hard dollar" payments, thereby implicating broker-dealers' status under the Advisers Act, and potentially subjecting such firms to regulation as investment advisers. This tension between U.S. and MiFID II regulatory regimes spurred SIFMA and other industry participants to seek relief from the SEC, which the SEC staff addressed in its October 2017 no-action letter and its initial extension.

While the no-action relief has expired, European regulators announced in June 2023 that reforms to MiFID II would amend the current research payment rules and re-introduce bundling, if proper disclosure is made to clients.

In response to the expiration, SEC Commissioner Mark Uyeda released a statement noting his disappointment, and expressed concern that restrictions to broker-dealer research could result in increased usage of less credible sources of information, which could potentially impact market prices and volatility adversely. Commissioner Uyeda further suggested that the SEC should consider harmonizing rules for investment research to help better facilitate an informed marketplace. The SEC's position has also been subject to bipartisan pressure from the U.S. Congress. On July 11, 2023, the House of Representatives passed H.R. 2622, directing the SEC to extend the no-action relief for six months, conduct a study of the impact of allowing expiration or maintaining the effectiveness of the no-action relief, and report on findings and conclusions to applicable Congressional committees. On July 12, H.R. 2622 was referred to the Senate, which is separately considering companion bill, S. 2141. While it is not clear whether and how the actions contemplated by the House and Senate legislation can be enforced if ultimately passed into law, there is some hope that future relief is possible. In the interim, the industry remains in a state of limbo, without no-action relief and with few commercially effective solutions.

Wayne M. Aaron, a shareholder in our Investment Services group, previously discussed the implications of the no-action relief's expiration in a summary available here. Our prior summary of the no-action relief is available here.

Regulatory Agenda Highlights Potential and Pending SEC Rulemaking Topics

On June 13, 2023, the Office of Information and Regulatory Affairs—part of the Office of Management and Budget, within the Executive Office—released the latest Unified Agenda of Regulatory and Deregulatory Actions, reporting on potential rulemaking topics that administrative agencies, including the SEC, will consider in the short and long term, including several areas of interest to funds, advisers and financial institutions, with topics categorized in one of three rulemaking stages: proposed rule, final rule and long-term actions.

Proposed Rule Stage. Matters identified in the proposed rule stage include the following:

- amendments to the rule governing the registration of "internet advisers" under the Advisers Act;
- digital engagement practices for investment advisers and broker-dealers, including rules related to the use of predictive data analytics, artificial intelligence, machine learning and similar technologies in connection with certain investor interactions;
- rules to enable issuers of index-linked annuities to register on a form tailored specifically to such insurance products—a new development stemming from the December 2022 passage of the Registered Index-Linked Annuities (RILA) Act as part of the 2023 Omnibus Appropriations bill;
- the listing and trading of exchange-traded products (ETPs) on national securities exchanges relating to a 2015 SEC request for comment;
- registered investment companies' fees and fee disclosure—a topic that first appeared in the spring 2022 regulatory agenda but has not yet resulted in any SEC release;
- Regulation D and Form D amendments, including updates to the accredited investor definition; and
- registrant disclosures regarding human capital management.

Final Rule Stage. Matters identified in the final rule stage include the following:

- enhanced disclosures by investment advisers and funds about environmental, social and governance (ESG) practices;
- investment company names rule;
- open-end fund liquidity and dilution management;
- rules relating to transparency, conflicts of interest and certain other matters involving private fund advisers, and documentation of adviser compliance reviews;
- outsourcing by investment advisers and rules related to advisers' oversight of third-party service providers;
- investment adviser disclosures and governance relating to cybersecurity risks;
- custody rules for investment advisers;
- Form PF and reporting requirements for investment advisers to private funds;
- amendments to require broker-dealers, investment companies and investment advisers to adopt written incident response procedures, including notification for compromises of sensitive customer information;
- amendments to the definition of dealer; and
- proposed Regulation Best Execution which would require detailed policies and procedures for all broker-dealers and more robust policies and procedures for broker-dealers engaging in certain conflicted transactions with retail customers, as well as related review and documentation requirements.

Long-Term Actions. Matters identified in the "long-term actions" stage of rulemaking include the following:

- the role of certain third-party service providers, including index providers, model portfolio providers and pricing services, their treatment under the Advisers Act and the implications for the asset management industry; and
- the regulatory regime for transfer agents.

The SEC's rule list for topics identified in the final rule or proposed rule stage is available here; the "long-term actions" list is available here. SEC Chair Gary Gensler issued a statement in connection with the release of the regulatory agenda.

SEC Staff's Latest Risk Alert Highlights Additional Focus Areas for Compliance with the Adviser Marketing Rule

On June 8, 2023, the SEC's Division of Examinations issued a risk alert highlighting certain additional areas of emphasis for upcoming examinations focused on the new investment adviser marketing rule, which took effect on November 4, 2022 and replaced the previous advertising and cash solicitation rules under the Advisers Act. The risk alert follows a September 19, 2022 publication in which the SEC staff initially identified focus areas for examinations relating to the new marketing rule.

In its latest risk alert, the Division's staff notes that it will continue to focus on areas previously identified in the earlier risk alert, including the implementation of policies and procedures reasonably designed to prevent violations of the marketing rule, the rule's substantiation requirement, compliance with the rule's performance advertisement requirements and related books and records requirements.

Continuing Review for Compliance with the General Prohibitions

The staff also noted that, as a component of examinations including a review of advisers' marketing practices, the Division will continue to focus on compliance with general prohibitions, such as making an untrue statement of a material fact, or omitting a material fact necessary to make the statement made, in light of the circumstances under which it was made, not misleading.

Other general prohibitions include:

- Including 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 clients or investors connected with or resulting from the adviser's services or methods of operation without providing fair and balanced treatment of any associated material risks or limitations;
- Referencing specific investment advice provided by the adviser in a manner that is not fair and balanced;

- Including or excluding performance results, or, presenting performance time periods, in a manner that is not fair and balanced; or
- Including information that is otherwise materially misleading.

Additional Marketing Rule Areas of Emphasis
The risk alert signaled that the other aspects of the marketing rule subject to SEC staff scrutiny generally relate to testimonials and endorsements, third-party ratings and Form ADV disclosures, as follows:

- Testimonials and Endorsements. The staff is reviewing whether advisers are in compliance with requirements regarding the use of testimonials and endorsements, including whether:
  - disclosures are provided, including clear and prominent disclosure of whether the person giving the testimonial or endorsement is a client or investor, that the promoter is compensated, if applicable, and of material conflicts of interest;
  - oversight conditions are met, such as whether advisers have a reasonable basis for believing that the testimonials or endorsements disseminated comply with the rule's requirements;
  - written agreements are entered into, where required, such as written agreements with promoters (subject to certain limited exceptions under the rule); and
  - ineligible persons (e.g., "bad actors") have been compensated for testimonials or endorsements (subject to certain limited exceptions under the rule).
- Third-Party Ratings. The staff is reviewing whether advisers are in compliance with the rule's requirements regarding the use of third-party ratings in advertisements, including whether:
  - the adviser provides, or reasonably believes that the third-party rating provides, clear and prominent disclosure of: (i) the date on which the rating was given and the period of time upon which it was based; (ii) the identity of the third party that created and tabulated the rating; and (iii) if applicable, that compensation has been provided directly or indirectly by the adviser in using or obtaining the rating.
  - questionnaires or surveys used in preparation of a third-party rating meet certain conditions, such as that the adviser has a reasonable basis for believing that it is structured to make it equally easy for a participant to provide favorable and unfavorable responses, and not in a way that would produce any predetermined result.
- Form ADV. The staff is reviewing whether advisers accurately completed the new subsection to Item 5 of Form ADV Part 1A regarding the adviser's marketing activities in connection with annual updating amendment filings.

The SEC staff encouraged investment advisers to assess their practices, policies and procedures in light of the additional examination review areas and, as necessary, to implement appropriate modifications to training, supervisory, oversight and compliance programs.

The risk alert is available here.

Litigation and Enforcement Matters

ENFORCEMENT DEVELOPMENTS

SEC Settles Enforcement Proceeding Against a Private Equity Fund Adviser for Overcharging Fees and Failing to Disclose Conflict

On June 20, 2023, the SEC announced the settlement of administrative proceedings brought against a registered investment adviser that manages various private equity funds that was alleged to have charged excess management fees and to have failed to disclose a conflict of interest related to its fee calculations. The issue arose in connection with the adviser's application of its permanent impairment policy, which involved the application of criteria developed and applied by the adviser to assess whether an investment was "permanently impaired."

According to the SEC's order, if the adviser were to determine that a fund's portfolio investment was permanently impaired pursuant to its policy, the adviser would be required to reduce the basis used to calculate the management fee the fund pays to the adviser. The adviser thus had an incentive not to determine that an investment was permanently impaired, creating a conflict of interest. The SEC alleged that the adviser did not disclose this conflict.

The SEC further alleged that the criteria used by the adviser to determine whether a portfolio investment was permanently impaired were "narrow and subjective," and that the adviser applied the criteria inaccurately by assessing permanent impairment at the aggregated portfolio company level rather than at the individual portfolio investment level, as required by the funds' limited partnership agreements. As a result, the SEC alleged that the adviser charged the funds $773,754.41 in excess fees during the relevant period. The adviser reimbursed this amount plus interest of $91,203.76 to the funds in May 2023 following the discovery of the matter in a previous investigation by the SEC's Division of Examinations.

The SEC found that the adviser willfully violated Section 206(2) of the Investment Advisers Act of 1940, which makes it unlawful for an adviser to engage in fraud or deceit upon any client or prospective client, Section 206(4) of and Rule 206(4)-8 under the Advisers Act, which make it unlawful for any adviser to make a materially false or misleading statement to, or engage in fraudulent, deceptive or manipulative practices with respect to, any investor or prospective investor in a pooled investment vehicle, and Section 206(4) of and Rule 206(4)-7 under the Advisers Act, which require advisers to adopt and implement written policies and procedures reasonably designed to prevent violations. Without admitting or denying the allegations, the adviser agreed to cease and desist from future violations, to be censured, to pay disgorgement and prejudgment interest in the amounts set forth above (which the May 2023 payments noted above were deemed to satisfy) and to pay a $1.5 million civil money penalty.

The order is available here and the accompanying press release is available here.

SEC Settles Enforcement Proceeding Against a Mutual Fund Adviser for Miscalculating Fee Waiver

On June 16, 2023, the SEC announced the settlement of administrative proceedings brought against a registered investment adviser for allegedly failing to correctly waive certain advisory fees for a mutual fund it manages consistent with its agreement with the fund. The fund in question is a "fund of funds" that invests primarily in other funds managed by the same adviser. The adviser contractually agreed to reduce its advisory fee to the extent that the adviser received a threshold amount of advisory, supervisory and administrative fees from the underlying funds in which the fund invests that are managed by the adviser. The SEC alleged that between 2011 and 2017, the adviser failed to waive approximately $27 million of the fund's advisory fees due to an error in the formula the adviser created to be used by the fund's sub-administrator to calculate the fee waiver amount.

According to the SEC's order, the miscalculation occurred because the adviser's formula failed to incorporate the fund's use of leverage and the potential impact leverage might have on the waiver calculation. The SEC alleged that the sub-administrator discovered the error and immediately informed the adviser. The adviser subsequently hired third parties to investigate and evaluate the matter and notified the fund's board and shareholders. The adviser implemented a remediation plan and reimbursed the fund's shareholders for over $30 million in unwaived fees, lost performance and interest.

The SEC alleged that the adviser willfully violated Section 206(4) and Rule 206(4)-7 under the Investment Advisers Act of 1940, which require advisers to adopt and implement written policies and procedures reasonably designed to prevent violations. Without admitting or denying the allegations, in settlement of the charges, the adviser agreed to cease and desist from future violations, to be censured and to pay a civil monetary penalty of $2.5 million. As stated in the order, the SEC considered the remedial acts promptly undertaken by the adviser in determining to accept the offer of settlement.

The order is available here and the accompanying press release is available here.

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Investment Services Group

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