Investment Services Regulatory Update

April 2024

Monthly Version

VedderPrice

New Rules, Proposed Rules, Guidance and Alerts

NEW AND PROPOSED RULES

SEC Adopts Amendments to Narrow the Internet Adviser Exemption

On March 27, 2024, the SEC adopted amendments to Rule 203A-2(e) (the Internet Adviser Exemption) under the Investment Advisers Act of 1940 to narrow the types of small investment advisers that can register with the SEC in reliance on the Internet Adviser Exemption. Section 203A of the Advisers Act generally prohibits investment advisers from registering with the SEC unless the adviser has at least $25 million in assets under management or advises a registered investment company. The Internet Adviser Exemption permits advisers with less than $25 million in assets under management to register with the SEC if they provide investment advice to all clients exclusively through an interactive website, subject to a de minimis exception permitting investment advice to fewer than 15 non-internet clients during the preceding 12 months.

The amendments to the Internet Adviser Exemption were adopted substantially as proposed and will require an adviser relying on the Exemption to provide investment advice to all clients exclusively through an operational interactive website at all times during which the adviser relies on the Exemption. The amendments clarify that an operational interactive website means websites, mobile applications or similar digital platforms through which the adviser provides digital investment advisory services on an ongoing basis (except during temporary technological outages of a de minimis duration) to more than one client, and that a "digital investment advisory service" is investment advice to clients that is generated by the operational interactive website's software-based models, algorithms, or applications based on personal information each client supplies through the website. Human-directed, client-specific investment advice, even if delivered through electronic means, would not be eligible activity under the amended Exemption. The amendments also eliminate the de minimis exception, thereby requiring advisers relying on the Exemption to provide investment advice to all clients exclusively through an operational interactive website, and require advisers to provide a representation on their Form ADV that they have an operational interactive website. An adviser that is no longer eligible to rely on the amended Exemption and that does not otherwise meet the requirements for registration with the SEC must register in one or more states and withdraw its registration with the SEC by filing a Form ADV-W by June 29, 2025.

The amendments will become effective on July 8, 2024, and the compliance date is March 31, 2025. The adopting release is available here, a related fact sheet is available here and a related press release is available here.

SEC Adopts Rules to Enhance and Standardize Climate-Related Disclosures

On March 6, 2024, the SEC voted 3-2 to adopt final rules requiring public companies, excluding investment companies but not excluding business development companies, to disclose climate-related information in their registration statements and annual reports. Following multiple lawsuits challenging the final rules, the SEC voluntarily stayed the final rules on April 4, 2024 pending resolution of the consolidated lawsuits, as discussed below.

The final rules will require public companies to disclose, among other matters, information about climate-related risks that have had or are reasonably likely to have a material impact on the company's business strategy, results of operations, or financial condition; the actual and potential material impacts of those risks; activities to mitigate or adapt to such risks; the process for identifying, assessing, and managing those risks; the board of directors' oversight of climate-related risks; information on any material climate-related targets or goals; and the financial statement effects (e.g., costs and losses) of severe weather events and natural conditions (e.g., hurricanes, flooding, drought, wildfires, and sea level rise). The final rules scale back certain requirements in the March 2022 proposing release, including by requiring disclosure of material Scope 1 and Scope 2 greenhouse gas emissions (GHG) only for large accelerated filers and accelerated filers, and eliminating Scope 3 GHG emission disclosure requirements altogether. The SEC received over 4,500 unique comment letters and over 18,000 form letters in response to the proposing release.

The required compliance dates for the final rules will be phased in and are dependent upon whether the company is a large accelerated filer, accelerated filer, non-accelerated filer, smaller reporting company, or emerging growth company, and are also dependent on the particular required disclosure. The earliest compliance requirements apply with respect to fiscal years beginning in 2025, and the latest apply to fiscal years beginning in 2033.

The SEC's adoption of the final rules was met nearly immediately with lawsuits from attorneys general of numerous states and other parties filed across numerous U.S. Circuit Courts of Appeals. On March 21, 2024, the cases were consolidated in the Eighth Circuit. Seeking to facilitate the resolution of the legal challenges, the SEC voluntarily stayed the final rules on April 4, 2024, pending the Eighth Circuit's review of the consolidated cases.

The adopting release is available here, a related fact sheet is available here, and a related press release is available here.

GUIDANCE AND OTHER DEVELOPMENTS

SEC Staff Risk Alert Focuses on Preparations for T+1 Settlement

On March 27, 2024, the staff of the SEC's Division of Examinations issued a risk alert highlighting its intent to focus during examinations and outreach on market participants' preparations for the shortening of the standard settlement cycle for most broker-dealer transactions from two business days (T+2) to one business day (T+1) after the trade date, with compliance required by May 28, 2024. The risk alert follows the February 15, 2023 SEC adoption of final rules to shorten the standard settlement cycle, as summarized by attorneys in Vedder Price's Investment Services group here.

The staff noted that the transition to T+1 settlement will impact various market participants, requiring changes to their business practices, computer systems and technology solutions, as well as potential changes to how participants comply with existing regulatory requirements, and emphasized that market participants must prepare for and understand these impacts in order to successfully manage the transition. The staff also highlighted the impacts of other new rules and rule amendments designed to facilitate T+1 settlement, which will also require compliance by May 28, 2024, including changes to institutional trade processing by broker-dealers and certain clearing agencies, as well as adviser recordkeeping.

T+1: Amendments to Rule 15c6-1 under the Securities Exchange Act of 1934

Subject to certain exceptions, the amendments to Rule 15c6-1 under the Exchange Act will prohibit broker-dealers from effecting security purchase or sale transactions that provide for payment of funds and delivery of securities (i.e., settlement) later than T+1, unless otherwise expressly agreed to by the parties at the time of the transaction.

Institutional Trade Processing: New Exchange Act Rules 15c6-2 and 17Ad-27

To facilitate T+1 settlement, new Rule 15c6-2 under the Exchange Act will require broker-dealers either to enter into written agreements with the relevant parties or to establish, maintain and enforce written policies and procedures reasonably designed to ensure completion of allocations, confirmations and affirmations (ACAs) for institutional securities transactions as soon as technologically practicable and no later than the end of trade date. Additionally, new Rule 17Ad-27 under the Exchange Act will require clearing agencies that are central matching service providers (CMSPs) (as defined in the Exchange Act) to establish, implement, maintain and enforce written policies and procedures reasonably designed to facilitate straight-through processing (STP) of securities transactions (i.e., automated securities transaction processing) and to file an annual report regarding their progress in facilitating STP.

Recordkeeping: Amendments to Rule 204-2 under the Investment Advisers Act of 1940

The SEC also adopted amendments to the recordkeeping requirements under Rule 204-2 under the Advisers Act to require advisers to "make and keep records of the allocations, confirmations, and affirmations for securities transactions subject to the requirements of Rule 15c6-2."

Examinations and Outreach

The staff noted that in reviewing and assessing preparations for T+1 settlement through examinations and outreach, it may review, among other things:

- whether and how market participants have evaluated the potential impact of the final rules on their business activities, operations and risk assessments, services, and customers, clients and/or other relevant parties;
- preparations related to clearance and settlement, custodial or prime brokerage services, securities lending recall activities and payment activities, trade allocation and trade fail management, and custodian communication;
- preparations related to operational readiness (e.g., changes to systems, policies or processes, and information related to any testing events);
- disclosures, representations and/or communications to customers, clients and/or vendors regarding changes related to T+1 settlement; and
- preparations related to the ACA process and any changes to written agreements or processes, policies and procedures designed to facilitate STP, and new recordkeeping and reporting requirements.

The risk alert also includes in an appendix the types of information and documents that may be reviewed in examinations and outreach. The staff encourages market participants to review the February 15, 2023 adopting release and related guidance in preparation for the transition to T+1 settlement.

The risk alert is available here and the related announcement is available here.

Highlights from SEC Speaks 2024

The SEC held its annual SEC Speaks conference—after a hiatus in 2023—on April 3 and 4, 2024 in Washington, D.C. The conference featured remarks from Chair Gary Gensler, Commissioner Hester Peirce, Commissioner Mark T. Uyeda, and Director of the Division of Enforcement Gurbir S. Grewal, as well as panel discussions addressing current SEC initiatives, priorities, and enforcement trends for the upcoming year. The conference speakers and panels also provided an update on litigation, judicial, and legislative developments.

The panels emphasized the SEC's three-fold mission of (i) protecting investors, (ii) maintaining fair, orderly, and efficient markets, and (iii) facilitating capital formation. Highlights from this year's conference included significant discussion of the treatment of cryptocurrency assets; the SEC's focus on individual accountability, self-reporting and cooperation considerations; the SEC's active whistleblower program; and other enforcement and examination trends from the past year.

On April 8, 2024, attorneys in Vedder Price's Government Investigations & White Collar Defense group published an article discussing highlights from the conference, available here.

Litigation and Enforcement Matters

LITIGATION DEVELOPMENTS

D.C. District Court Overturns SEC Proxy Advisor Rule, Holding Proxy Voting Advice Is Not Solicitation

On February 23, 2024, the U.S. District Court for the District of Columbia, in a case dating back to 2019, vacated certain SEC rule amendments regarding proxy advisory firms, holding that "the SEC acted contrary to law and in excess of statutory authority when it amended the proxy rules' definitions of "solicit" and "solicitation" to include proxy voting advice for a fee."

In August 2019, the SEC issued an interpretation and related guidance in which it expressed its view that proxy voting advice furnished by proxy advisory firms generally constitutes a "solicitation" for purposes of Section 14(a) of the Securities Exchange Act of 1934 and the proxy rules. The plaintiff in this case, proxy advisory firm Institutional Shareholder Services, Inc., filed suit in October 2019 to contest the SEC's extension of the proxy rules to proxy voting advice, claiming that proxy advisory firms do not "solicit" proxies because proxy advisory firms "do not seek proxy authority or ask shareholders to vote a certain way to achieve a particular outcome." According to the SEC, proxy advisory firms move shareholders to vote or endeavor to obtain votes consistent with their advice and therefore "solicit" proxies. In November 2019, the SEC issued a proposed rulemaking, followed by a final rulemaking in July 2020, which formally amended the proxy rules' definitions of "solicit" and "solicitation" to expressly include the furnishing of proxy voting advice for a fee. As outlined in the court's opinion, this case has been stayed or otherwise suspended multiple times, pending further SEC regulatory action in this area. The SEC issued a subsequent final rulemaking in July 2022 rescinding certain aspects of the July 2020 rulemaking, after which the case proceeded.[1]

As stated by the court, summary judgment is appropriate when "there is no genuine dispute as to any material fact in the case and the movant is entitled to judgment as a matter of law." In granting summary judgment in favor of the plaintiff proxy advisory firm, the court held that "the ordinary meaning of 'solicit' at the time of Section 14(a)'s enactment does not reach proxy voting advice for a fee" and therefore, by defining "solicit" and "solicitation" in such a way, "the SEC acted contrary to law and in excess of statutory authority." In its reasoning, the court noted that "a proxy advisory firm offers advice on how to vote, but it does not seek to obtain a proxy." Additionally, the court noted that where a proxy advisory firm casts votes on behalf of clients, the "administrative act of casting a vote consistent with its advice does not make the advice itself a 'solicitation.'" The court also noted that proxy advisory firms have no personal interest in a vote's outcome. As a result of its holding, the court vacated the definitional amendment to the proxy rules adopted by the SEC.

The court's memorandum opinion was issued under the caption *Institutional Shareholder Services Inc. v. Securities and Exchange Commission et al.*, Civil 19-cv-3275 (APM) (D.D.C. Feb. 23, 2024).

[1]Attorneys in Vedder Price's Investment Services group previously published articles on the August 2019 guidance, November 2019 proposing release, July 2020 adopting release, and July 2022 adopting release.

ENFORCEMENT DEVELOPMENTS

SEC Settles Charges Against Advisers for Alleged False and Misleading Statements About Their Use of Artificial Intelligence

On March 18, 2024, the SEC announced that it had settled charges against two investment advisers for allegedly making false and misleading statements about their use of artificial intelligence (AI) in providing advisory services, so-called "AI washing."

According to the first order, between 2019 and 2023, the adviser represented in public disclosures that it used AI and machine learning to collect and analyze its retail clients' spending and social media data to inform the investment algorithms utilized by its robo-adviser business to provide investment advice, when in fact no such data was being used in its investment process. During the relevant period, such statements regarding the adviser's AI and machine-learning capabilities and use of client data were included in various public disclosures, including in its Form ADV, in press releases and on its website. In a 2021 SEC examination, the adviser acknowledged that it had not developed the advertised AI and machine-learning capabilities or utilized client data as described. Despite undertaking certain remedial actions following the examination, the adviser allegedly continued to make similar false and misleading statements in advertisements through August 2023.

In the second order, the SEC alleged that the adviser made false and misleading claims on its website, in emails to current and prospective clients, and on social media regarding its use of AI in its interactive online platform, which makes investment allocation recommendations to clients. For example, the adviser claimed to be the "first regulated AI financial advisor" and that its technology incorporated "[e]xpert AI-driven-forecasts," claims that the SEC states the adviser was unable to substantiate. The order also cited a number of other alleged false and misleading statements and violations unrelated to the adviser's purported use of AI.

The SEC found that the advisers willfully violated Section 206(2) of the Investment Advisers Act of 1940, which makes it unlawful for any adviser to engage in a transaction, practice or course of business that operates as a fraud or deceit upon a current or prospective client; Section 206(4) of the Advisers Act and Rule 206(4)-1 thereunder, which prohibit any registered investment adviser from disseminating any advertisement that includes any untrue statement of material fact or omits to state a material fact necessary in order to make the statement made not misleading or includes 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 investment adviser; and Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, which require registered investment advisers to adopt and implement written compliance policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder. Without admitting or denying the SEC's findings, the advisers each consented to cease and desist from future violations and to censure. The advisers agreed to pay civil penalties of $225,000 and $175,000, respectively, and in each case, the SEC considered the cooperation afforded to the SEC staff.

The SEC's orders are available here and here. A related press release is available here.

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Investment Services Group

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