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Investment Management

JANUARY 2021 • NO. 1

Regulatory Update and Recent SEC Actions

REGULATORY UPDATES

SEC Proposes Conditional Exemption for Finders Assisting Small Businesses with Capital Raising

On October 7, 2020, the Securities Exchange Commission (the "SEC") proposed a conditional exemption from broker registration requirements for certain "finders" who assist issuers with raising capital in private markets. If adopted, the proposed exemption would permit natural persons to engage in certain limited activities involving accredited investors without registering with the SEC as brokers. The proposed exemption seeks to assist small businesses in raising capital and to provide regulatory clarity to investors, issuers, and the finders who assist them. The proposed exemption would establish guidelines for both registered broker activity and limited activity by finders that would be exempt from registration.

"Many small businesses face difficulties raising the capital that they need to grow and thrive, particularly when they are located in places that lack established, robust capital raising networks," said then-Chairman Jay Clayton. "If adopted, the proposed relief will bring clarity to finders' regulatory status in a tailored manner that addresses the capital formation needs of certain smaller issuers while preserving investor protections."

SEC Updates Auditor Independence Rules

On October 16, 2020, the SEC adopted amendments to certain auditor independence requirements that are meant to modernize the rules and focus the analysis on relationships and services that may pose threats to an auditor's objectivity and impartiality. The amendments stem from the SEC's observation of recurring fact patterns where certain relationships and services triggered technical independence rule violations without necessarily actually impairing an auditor's objectivity and impartiality. The SEC noted that these scenarios either triggered non-substantive rule breaches or required time-consuming audit committee review of non-substantive matters.

The SEC first solicited suggestions for additional revisions to the auditor independence rules in its proposing release for the rule relating to auditor independence and loans and credit/debtor relationships (the "Loan Rule") back in May 2018, and issued the proposing release for the current additional amendments to Rule 2-01 of Regulation S-X in December 2019. The amendments as contained in the October 2020 adopting release respond to recent changes in the capital markets and incorporate both recent and long-term feedback. Among other provisions, the rule amendments:

(i) amend the definitions for "affiliate of the audit client" and "investment company complex" to address certain affiliate relationships, including entities under common control; (ii) add certain student loans and *de minimis* consumer loans to the exclusions from independence-impairing lending relationships; and (iii) address inadvertent independence violations arising solely as a result of a merger or acquisition transaction. The final amendments establish a "dual materiality" threshold such that a sister entity would be deemed an affiliate of the audit client only when both the entity under audit and the sister entity are material to the controlling entity. The SEC further noted that the amendments will also improve competition and audit quality by increasing the number of qualified audit firms from which an issuer can choose. Voluntary early compliance prior to the effective date, which is 180 days after the rule amendments are published in the Federal Register, is permitted. The rule amendments may not be applied retroactively to relationships and services in existence prior to the effective date of the amended rule (or the early compliance date if selected).

"Today's amendments reflect the Commission's long-recognized view that an audit by an objective, impartial, and skilled professional contributes to both investor protection and investor confidence," said then-Chairman Jay Clayton. "These modernized auditor independence requirements will increase investor protection by focusing audit clients, audit committees, and auditors on areas that may threaten an auditor's objectivity and impartiality."

SEC and CFTC Approve Final Rule on Security Futures Margin and Issue a Request for Comment on Portfolio Margining

On October 22, 2020, the SEC and the Commodity Futures Trading Commission ("CFTC") approved a joint final rule to harmonize the minimum margin level for security futures held in a futures account with the minimum margin level for security futures held in a securities portfolio margin account. The rule lowers the margin requirement for an unhedged security futures position from 20 percent to 15 percent and adopts certain conforming revisions to the security futures margin offset table. The SEC and CFTC also issued a joint request for comment on possible methods for implementing portfolio margining of SEC and CFTC regulated products (including swaps, security-based swaps, securities, and futures). The request for comment seeks input from market participants on all facets of portfolio margining including (i) the risks of margining uncleared swaps and security-based swaps positions, and (ii) the regulatory and operational issues that are posed by such margining.

"The markets the CFTC and SEC regulate are highly interconnected, so coordination is vital to regulatory effectiveness. The historic joint open meeting of our two agencies reflects our strong commitment to cooperation and harmonizing our efforts where appropriate," said CFTC Chairman Heath P. Tarbert.

SEC Adopts Modernized Regulatory Framework for Derivatives Use by Registered Funds and Business Development Companies

On October 28, 2020, the SEC adopted Rule 18f-4 of the Investment Company Act (the "1940 Act") to enhance the regulatory framework for derivatives use by registered investment companies, including mutual funds (other than money market funds), exchange-traded funds ("ETFs"), and closed-end funds, as well as business development companies. The SEC noted that the new rule is intended to provide a modernized, comprehensive approach to the regulation of derivatives use while enhancing investor protections. The rule permits funds to enter into derivative transactions subject to certain requirements, including the adoption of a derivatives risk management program and limits on the amount of leverage-related risk a fund may hold based on value-at-risk ("VaR"), compliance with which is to be confirmed on a daily basis. The derivatives risk management program must identify and assess the fund's derivatives risks and provide for the establishment, maintenance, and enforcement of risk guidelines, stress testing to evaluate potential losses under stressed conditions, back-testing of the VaR calculation model used by the fund and internal reporting and escalation provisions. The VaR limits in the final rule were increased from the percentages in the proposing release to 200 percent of the VaR of a fund's designated reference portfolio or, if the fund is subject to an absolute VaR test, the fund's VaR cannot exceed 20 percent of the value of the fund's net assets (except that closed-end funds with preferred shares outstanding may not exceed 250 percent of the VaR of the fund's designated reference portfolio).

Under the final rule, the fund's board is not specifically required to approve the program but is required to approve the appointment of a derivatives risk manager ("DRM") for the fund. The DRM must be an officer or officers of the fund's investment adviser and is required to administer the program and report to the fund's board on the program's implementation and effectiveness, including stress testing and back-testing results and any breaches of the fund's risk guidelines. The rule provides a limited user exception from the program and VaR test requirements if the fund's derivatives exposure is limited to 10 percent of its net assets (excluding certain currency and interest rate hedging transactions) provided that the fund adopts and implements written policies and procedures reasonably designed to manage its derivatives risks.

The rule also allows funds to enter into reverse repurchase agreements and similar financing transactions so long as they meet the Section 18 asset coverage requirements, and to enter into unfunded commitment agreements if the fund reasonably believes, at the time of entering into any such agreement, that it will have sufficient cash and cash equivalents to meet its obligations under the agreement. Funds, including money market funds, will now be permitted to invest in securities on a forward-settling basis, subject to reporting and recordkeeping requirements.

Related form amendments were also adopted, requiring funds to confidentially report on Form N-RN if they are out of compliance with a fund's VaR-based limits for more than five business days. A fund that is currently required to file reports on Forms N-PORT and N-CEN will be required to provide certain information regarding its derivatives use, including information regarding the fund's VaR, as applicable, and information about the fund's derivatives exposure (for funds that rely on the limited user exception). The SEC abandoned the alternative framework and sales practice rules it had provided for leveraged or inverse ETFs in its proposing release. Instead, the final rule also applies to leveraged or inverse ETFs. However, the rule provides an exception from the VaR requirement for leveraged or inverse ETFs in operation, subject to the satisfaction of certain conditions. In addition, the SEC has directed its staff to consider whether additional requirements for these products may be appropriate.

The rule and related rule and form amendments will become effective 60 days after publication in the Federal Register. Funds have an 18-month transition period to comply with the rule and related reporting requirements. Additionally, the SEC will rescind Release 10666, which provided guidance on how funds may use certain derivatives and derivatives-like transactions in light of the policy objectives of Section 18 of the 1940 Act, and certain no-action letters and other guidance addressing derivatives use will also be withdrawn.

"Derivatives have come to play an important role for many funds in portfolio strategy and risk management, but the regulatory approach for derivatives use has been inconsistent and outdated," said then-Chairman Jay Clayton. "Today's action provides for a comprehensive framework for funds' derivatives use that provides both meaningful protections for investors and regulatory certainty for funds and their advisers. Importantly, the new comprehensive limits on risk will prohibit derivatives use that is inconsistent with the leverage limits imposed by the Investment Company Act, but will allow virtually all funds to continue to serve their investors using the most efficient instruments."

DOL Adopts Final Amendments to Investment Duties Regulation under ERISA Relating to ESG Investing

On October 30, 2020, the U.S. Department of Labor (the "DOL") announced the final version of the rule updating investment duties regulation under Title I of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). In its announcement, the DOL indicated that the new rule as finalized is intended to provide clear regulatory guideposts for fiduciaries of private-sector retirement and other employee benefit plans in light of recent trends involving environmental, social, and governance ("ESG") investing. The rule requires plan fiduciaries to select investments and investment courses of action based on "pecuniary" factors, which are defined in the new rule as factors that the fiduciary expects to have a material effect on risk and/or return of an investment based on appropriate investment horizons consistent with a plan's investment objectives and funding policy.

When proposed in June 2020, the rule received over 8,000 comment letters, most in opposition to the rule. The proposed rule was widely seen as an attempt to curb the use of ESG investments in retirement plans. Many asset managers and other opponents of the rule asserted that the rule was out of step and based on outdated assumptions, pointing out that ESG investments actually outperform traditional counterparts.

The DOL noted that the final rule contains "modifications in response to public comments," and that ESG factors, which are no longer explicitly referenced in the rule, "could be pecuniary in nature and that, in such cases, fiduciaries properly could consider the factors as part of their investment analysis." Opponents of the rule argue that the changes are insufficient and that the rule undermines socially responsible investing in retirement plans. The rule will be effective 60 days after publication in the Federal Register, but plans will have until April 30, 2022, to make any changes to certain qualified default investment alternatives where necessary. The rule's effective date is likely to be impacted by the change in administration. The Biden administration announced on January 20, 2020, that it would be reviewing the rule.

Executive Branch, PCAOB, and SEC Address Investments in Chinese Companies

The Trump administration, Congress, and regulators have recently introduced various rules and guidance relating to investments in Chinese companies that are designed to address China's restrictive approach to international business competition and to provide more transparency with respect to such investments.

On November 12, 2020, President Trump issued an executive order prohibiting investments in Chinese companies identified by the U.S. Defense Department as having ties to the Chinese military, arguing that such investments pose a risk to national security. The Treasury Department later clarified that this prohibition also applied to ETFs and index funds. (After weighing alleged Chinese military ties against the potential adverse economic impact of a ban, the Trump administration subsequently identified certain Chinese companies that would not be subject to the executive order.) The SEC also recently issued guidance that encouraged investment advisers, broker-dealers, and other market participants to review and assess the impact of the executive order for their own investments as well as on behalf of investors and clients, and to evaluate their related processes. On December 21, 2020, the NASDAQ removed shares of four Chinese construction and manufacturing companies from indexes it maintains, in response to the order. On December 31, 2020, the New York Stock Exchange ("NYSE") announced that it would delist China's three biggest state-run telecommunication companies. On January 4, 2020, the NYSE reversed its decision, saying that it would no longer delist the companies, but two days later the NYSE reversed course again, announcing that it would delist the companies.

The Trump administration and lawmakers also introduced new rules designed to put pressure on Chinese companies with securities listed on U.S. exchanges to allow their financial audits to be inspected by the Public Company Accounting Oversight Board ("PCAOB"). Similarly, then SEC Chairman Jay Clayton, PCAOB Chairman William Duhnke, SEC Chief Accountant Sagar Teotia, SEC Division of Corporation Finance Director William Hinman and SEC Division of Investment Management Director Dalia Blass issued a joint statement earlier this year concerning the inability of the PCAOB to inspect audits of Chinese issuers. In December 2020, Congress passed and President Trump signed into law the Holding Foreign Companies Accountable Act, which requires the SEC to ban trading on all U.S. exchanges of any foreign company for which the PCAOB is unable to inspect audit workpapers for three consecutive years. Likewise, the SEC and the PCAOB also have issued various guidance and statements with respect to investments in emerging companies and specifically Chinese companies over the past year. The NASDAQ also recently proposed a rule to deny listing and apply tougher criteria on issuers whose audits are not inspected by PCAOB.

On November 23, 2020, the SEC issued its most recent guidance in this area, which recognized the increased exposure of U.S. investors to companies based in or with the majority of their operations in China. The guidance warns investors of potential risks, including the lack of transparency, associated with investments in Chinese companies, and highlights what U.S. investors should consider as they seek to fulfill their disclosure obligations under the federal securities laws.

The status of the executive order and new regulations under the new Biden administration is uncertain.

SEC Leadership Changes

Jay Clayton concluded his tenure as chairman of the SEC at the end of 2020. Clayton, sworn in on in May 2017, left the SEC as one of its longest serving chairs. On December 28, 2020, the SEC announced that Elad L. Roisman had been designated as acting chairman. Roisman was sworn in as an SEC commissioner in the fall of 2018. On January 18, 2021, the Biden administration nominated Gary Gensler as the new chairman of the SEC to replace Clayton. Gensler served as chairman of the CFTC from 2009 to 2014. He helped to draft the Sarbanes-Oxley Act as senior advisor to U.S. Senator Paul Sarbanes and was undersecretary of the Treasury for Domestic Finance from 1999 to 2001, and assistant secretary of the Treasury for

Financial Markets from 1997 to 1999. On January 21, 2020, President Biden designated Allison Herren Lee as the new acting chair, replacing Roisman. Lee has been a commissioner with the SEC since the summer of 2019. From 2005 to 2018, Lee served on the staff of the SEC in various roles, including as counsel to Commissioner Kara Stein and as senior counsel in the Division of Enforcement's Complex Financial Instruments Unit. Lee will serve as acting chair until Gensler is confirmed.

Dalia Blass, the director of the Division of Investment Management since the fall of 2017, also announced her departure from the SEC. Under her leadership, the division finalized more than 70 regulatory initiatives affecting investment companies and investment advisers. Various other SEC staff recently announced their departure from the SEC, including the SEC's general counsel, chief of staff, chief economist, chief accountant, and deputy director and chief counsel of the Division of Investment Management.

SEC Adopts Rule Amendments to Facilitate Electronic Submission of Documents to the Agency

On November 17, 2020, the SEC adopted rule amendments that will permit the use of electronic signatures when executing documents filed with the SEC. The new rule amendment replaces the current requirement that each signatory to an electronic filing manually sign a signature page or other document before or at the time of the filing to authenticate the signature that appears in typed form within the filing. These amendments follow a rulemaking petition joined by nearly 100 public companies and recognize the widespread use of electronic signatures and technological developments in the authentication and security of electronic signatures, as well as the continuing need to support remote workforces. The rule amendments will be effective upon publication of the adopting release in the Federal Register. The SEC also adopted rule amendments to facilitate electronic filing and service of documents in administrative proceedings provided certain requirements are met, including the redaction of sensitive personal information, before filing with the SEC. These amendments will become effective 30 days after publication of the adopting release in the Federal Register. However, compliance will not be required until April 12, 2021, and there will be an initial 90-day phase-in period.

SEC Adopts Amendments to Modernize and Enhance Management's Discussion and Analysis and other Financial Disclosures for Public Companies, Including Business Development Companies

On November 19, 2020, the SEC adopted amendments to Regulation S-K that are intended to modernize Management's Discussion and Analysis ("MD&A") and other financial disclosure requirements for publicly listed companies, including business development companies. The amendments eliminate the requirement for selected financial data, streamline the requirement to disclose supplementary financial information, and update MD&A requirements to reduce duplicative disclosures and codify certain existing SEC guidance. In its adopting release, the SEC noted that this approach should yield material information relevant to an assessment of the financial condition and results of operations of the registrant, and allow investors to view the registrant from management's perspective. The amendments are also intended to improve disclosure by enhancing readability, discouraging repetition, and eliminating information that is not material. In a joint statement, the SEC's two democratic commissioners dissented from the adoption of the amendments, noting among other things the amendments failed to address factors that impact the long-term sustainability of an issuer; *e.g.,* climate risk and human capital management.

"Today's rules will improve the quality and accessibility of the disclosure that companies provide their investors, including, importantly giving investors greater insight into the information management uses to monitor and manage the business," said then-Chairman Jay Clayton. "The improved approach to these disclosures reflects the broad diversity of issuers in our public markets and will allow investors to make better capital allocation decisions, while reducing compliance burdens and costs and maintaining strong investor protection."

SEC Modernizes Framework for Fund Valuation Practices

On December 3, 2020, the SEC adopted the final rule intended to address registered investment company valuation practices and clarify the role of the board of directors with respect to

determining fair value. While fair valuation is the responsibility of the board under the 1940 Act, most boards delegate the day-to-day valuation role. Prior to the adoption of the new rule, boards generally have had to rely on SEC guidance and no-action letters issued over the years. The new rule expressly permits delegation of the valuation function. The new rule is also considered to codify certain valuation practices utilized in the fund industry. Under new Rule 2a.5, a board, or its designee, is required to (i) periodically assess material risks associated with fair value determinations, including conflicts of interest, and manage those risks; (ii) select and apply in a consistent manner appropriate methodologies for determining fair value, periodically review the accuracy of the methodologies selected and make necessary adjustments, and monitor for circumstances that necessitate the use of fair value; (iii) test the appropriateness and accuracy of the methodologies selected and evaluate the effectiveness of and the frequency with which those testing methods are used; and (iv) oversee and evaluate any pricing services used, including establishing the process for doing so and initiating price challenges.

Since most fund boards do not play a daily role in the pricing of fund investments, the rule permits a board to choose to designate the fund's investment adviser as the "valuation designee" to carry out all of the required functions related to the fair value determinations, subject to the board's oversight. The definition of valuation designee expressly excludes a fund's sub-adviser. The rule requires a valuation designee to (i) inform the board of the persons responsible for fair value determinations; (ii) segregate fair valuation determinations from the fund's portfolio manager; (iii) provide the board, at least quarterly, with reports related to fair value or the fair value process and, at least annually, with a written assessment of the effectiveness of the process for determining fair value, including a summary of the results of the testing of methodologies and an assessment of the adequacy of the resources allocated to the process; and (iv) notify the board of matters that materially affect the fair value of the fund's investments, within five business days after the adviser becomes aware of the matter (or shorter period as determined by the board).

The rule also provides that a market quotation is readily available for purposes of the 1940 Act only when that quotation is a quoted price (unadjusted) in active markets for identical investments that the fund can access at the measurement date, provided that a quotation will not be considered readily available if it is not reliable. The SEC also adopted new rule 31a-4, which requires funds or their advisers, as applicable, to maintain appropriate documentation to support fair value determinations and, where applicable, documentation related to the designation of the valuation designee. Finally, the SEC will rescind two releases, Accounting Series Release 113 and Accounting Series Release 118, which provided SEC guidance on, among other things, how to determine fair value for restricted securities. In addition, staff letters and other guidance addressing a board's determination of fair value will be withdrawn or rescinded. The rules become effective 60 days after publication of the release in the Federal Register, and the compliance date will be 18 months following the effective date. Funds will have the option of complying with the rules after the effective date but before the compliance date, however any fund that elects to do so may not also rely on previously issued SEC guidance and staff letters.

"Main Street investors increasingly access our capital markets through funds and rely on them to value their investments properly," said then-Chairman Jay Clayton. "Today's rule is designed to improve funds' valuation practices, including by providing for effective board oversight, for the benefit and protection of fund investors."

Democrats Introduce Bills Requiring Investment Advisers and Plan Fiduciaries to Establish ESG Investment Policies

On December 14, 2020, Rep. Andy Levin (D-Mich.), Rep. Brendan Boyle (D-Pa.), and Rep. Cindy Axne (D-Iowa) introduced two bills that would require asset managers, investment advisers, and retirement plan fiduciaries to divulge how they incorporate ESG factors into investment decisions. The Sustainable Investment Policies Act, which is intended to amend the Investment Advisers Act of 1940 (the "Advisers Act"), would require large asset managers and other investment advisers to establish policies detailing how they consider specific ESG factors when investing, and to disclose those policies. The bill does not require asset managers to disclose all of the details about the companies they invest in, but instead asks them to consider these factors to the extent they can, and provide details on their process for doing so.

Another bill introduced by Levin and his colleagues, the Retirees Sustainable Investment Policies Act, mirrors the Sustainable Investment Act but would apply to fiduciaries of retirement and welfare benefit plans covered by the ERISA. The bill intends to amend ERISA to state that plan fiduciaries may choose investments with ESG considerations, including

Qualified Default Investment Alternatives ("QDIAs") that include an ESG mandate. The proposed legislation comes about six weeks after the DOL finalized its rule amendments, which hold plan fiduciaries to a "pecuniary" standard for selecting retirement plan investment options. The final DOL rule is viewed by some as making it more difficult to consider ESG factors in choosing investment options.

"The provision is intended to explicitly, legislatively reverse the recent Department of Labor rule and eliminate any remaining ambiguity going forward," said Legislative Counsel Sabrina Steel. "It is ludicrous that the DOL would tell fiduciaries to not consider factors that are relevant to plan beneficiaries in QDIAs, so fixing that is a top priority."

SEC Announces the Creation of the Security-Based Swaps Joint Venture

On December 18, 2020, the SEC announced the creation of the Security-Based Swaps Joint Venture ("SBS Joint Venture"), a collaborative venture among several SEC divisions and offices that will be responsible for coordinating functions related to the regulation of security-based swaps ("SBS") and oversight of certain entities that will be required to register with the SEC ("SBS entities"). The SEC noted that the SBS Joint Venture will be an important part of the SEC's efforts to regulate the SBS market, and will position the SEC to effectively monitor SBS transaction data as it implements the regulatory regime established by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). Beginning in November 2021, SBS entities will be required to register with the SEC and comply with various regulations relating to capital, margin, segregation, and transaction reporting. SBS entities will also be required to report their SBS transaction data, which will be used for various regulatory purposes, such as monitoring the build-up and concentration of risk exposures, preventing fraud, supervising systemic risk, and resolving issues and positions after an institution fails.

SEC Adopts Modernized Marketing Rule for Investment Advisers

On December 22, 2020, the SEC announced that it had finalized reforms under the Advisers Act to modernize the rules that govern adviser advertisements and payments to solicitors. The new rules reflect the SEC's experience administering the current rules by replacing broadly drawn limitations with principles-based provisions, recognizing that advertising methods and communications technology have evolved considerably since the current rules were adopted 40 years ago. The new rule requires advisers to standardize certain parts of their presentation of performance information, and includes general prohibitions against misleading or biased statements or omissions, as well as statements that cannot be substantiated by the adviser upon demand. Advertisements that include third-party ratings will be required to include specific disclosures to prevent them from being misleading, including (i) the date on which the rating was given and the period of time upon which the rating 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 connection with obtaining or using the third-party rating. The rule will also permit the use of testimonials and endorsements, which include traditional referral and solicitation activity, subject to certain disclosure, oversight, and disqualification provisions.

The SEC adopted related amendments to the investment adviser registration form and the books and records rule. The staff of the Division of Investment Management expects to withdraw no-action letters and other guidance addressing the application of the advertising and cash solicitation rules. A list of the letters will be available on SEC.gov.

"The marketing rule reflects important updates to the traditional advertising and solicitation regimes, which have not been amended for decades, despite our evolving financial markets and technology," said then-Chairman Jay Clayton. "This comprehensive framework for regulating advisers' marketing communications recognizes the increasing use of electronic media and mobile communications and will serve to improve the quality of information available to investors."

SEC Moves Toward Implementation of Security Based Swap Regulation under Dodd-Frank

On December 22, 2020, the SEC voted to take two actions to advance the implementation of security based swap regulation under Title VII of the Dodd-Frank Act. The SEC published a final substituted compliance order that provides that certain German firms that are registered with the SEC as security-based swap dealers and major security-based

swap participants may satisfy, subject to conditions, certain requirements under the Securities Exchange Act of 1934 ("Exchange Act") by complying with comparable German and European Union ("EU") requirements. The SEC also published a notice of application and proposed substituted compliance order in response to a similar application that seeks substituted compliance for French security-based swap entities based on compliance with French and EU requirements.

"Substituted compliance is a critical component to the workable yet effective regulation of the global OTC derivatives markets," said SEC Commissioner Hester Peirce. "I am pleased that the Commission is taking these steps, including considering substituted compliance with respect to capital and margin requirements in connection with the French application. I look forward to considering applications for substituted compliance for additional jurisdictions in the near future."

SEC Issues Statement and Requests Comment Regarding the Custody of Digital Asset Securities by Special Purpose Broker-Dealers

On December 23, 2020, the SEC issued a statement and request for comment regarding the custody of digital asset securities by broker-dealers. The statement sets forth conditions under which, during a five-year period, a special purpose broker-dealer may deem itself to have obtained and maintained physical possession or control of digital asset securities for the purpose of Rule 15c3-3 under the Exchange Act (the "Consumer Protection Rule"). The broker-dealer will not be subject to an SEC enforcement action provided the broker-dealer operates in compliance with the conditions outlined in the statement, including that the broker-dealer (i) limits its business to digital asset securities; (ii) establishes and implements policies and procedures reasonably designed to mitigate the risks associated with conducting a business in digital asset securities; and (iii) provides customers with certain disclosures regarding the risks of engaging in transactions involving digital asset securities. In its statement, the SEC recognized that the digital asset securities market is new and rapidly evolving and the technical requirements for transacting and custodying digital asset securities differ from those involving traditional securities.

Congress Amends Exchange Act, Expanding SEC Enforcement Power

On January 1, 2021, Congress passed legislation that expressly grants the SEC the authority to seek disgorgement in civil actions under the Exchange Act. The amendments to the Exchange Act also double the time period for which the SEC may obtain disgorgement in cases involving fraud, from five to 10 years. The amendments are a direct response to the Supreme Court's recent decisions in *Kokesh v. SEC* and *Liu v. SEC,* limiting the SEC's ability to obtain disgorgement.

ENFORCEMENT ACTIONS

SEC Charges Investment Advisory Firms and Broker-Dealers in Connection with Sales of Complex Exchange-Traded Products

On November 13, 2020, the SEC settled actions against three investment advisory firms and two broker-dealer and advisory firms for violations relating to unsuitable sales of complex exchange-traded products to retail investors. The sales occurred between January 2016 and April 2020. The actions all concern sales of volatility-linked exchange-traded products. The value of the products attempted to track short-term volatility expectations in the market, typically measured against derivatives of the Chicago Board Options Exchange volatility index. According to the orders, the offering documents made clear that the short-term nature of these products made investments in them more likely to experience a decline in value when held over a longer period. The orders find that, contrary to these warnings, and without understanding the products, representatives of the firms recommended that their customers and clients buy and hold the products for longer periods, including in some circumstances, for months and years. The orders further find that the firms failed to adopt or implement policies and procedures regarding suitability and volatility-linked exchange-traded products; and policies and procedures reasonably designed to prevent violations of the Advisers Act and its rules. The orders further find that certain of the firms failed reasonably to supervise certain brokerage and advisory representatives who recommended that their clients buy and hold two volatility-linked products.

Without admitting or denying the findings, each firm agreed to cease and desist from future violations of the charged provisions, a censure, and to pay disgorgement and prejudgment interest. The firms agreed to pay civil penalties

in the amounts of $650,000, $600,000, and $500,000. The five actions filed will result in the return of over three million dollars to harmed investors.

Investment Adviser Settles Anti-Fraud and Compliance Charges

On December 8, 2020, the SEC announced that a UK-based investment adviser ("Investment Adviser") agreed to pay $170 million to settle charges arising from inadequate disclosures and material misstatements and omissions concerning its transfer of top traders from its flagship client fund ("Flagship Fund"), to a proprietary fund ("Proprietary Fund"), replacement of those active traders with an underperforming algorithm with respect to Flagship Fund, and associated conflicts of interest. According to the order, Investment Adviser created Proprietary Fund to trade the personal capital of Investment Adviser personnel using primary trading strategies that overlapped with those of the Flagship Fund. The order also alleged that Investment Adviser failed to disclose that it reallocated the transferred traders' capital allocations in Flagship Fund to a semi-systematic trading system, which was essentially a replication algorithm that tracked certain trading activity of a subset of Investment Adviser's live traders and generated significantly less profit with greater volatility than the live traders. The order stated that the Investment Adviser also failed to disclose certain material facts about the algorithm to the Flagship Fund's independent directors.

The order found that Investment Adviser willfully violated antifraud provisions and the compliance rule of the federal securities laws. Without admitting or denying the SEC's findings, Investment Adviser agreed to a cease-and-desist order imposing a censure, and was required to pay disgorgement and prejudgment interest of $132,714,506 and a penalty of $37,285,494, all of which will be returned to investors.

SEC Charges Pricing Service with Compliance Deficiencies

On December 9, 2020, the SEC charged a global securities pricing service and New York-based registered investment adviser ("Pricing Service"), for compliance deficiencies relating to its delivery to clients of prices based on quotes it received from a single market participant, also known as single broker quotes. According to the order, from at least 2015 through September 2020, Pricing Service delivered to its clients prices based on single broker quotes while failing to adopt and implement policies and procedures reasonably designed to address the risk that these prices would not reasonably reflect the value of the securities. The order further finds that Pricing Service's quality controls for prices based on single broker quotes were not effectively or consistently implemented. The order finds that these failures impaired Pricing Service's ability to assess the reliability of quotes it received from market participants and determine whether a quote provider was an accurate source of information; and that this conduct affected the prices Pricing Service provided for more than 40,000 fixed-income securities. The SEC's order finds that, due to these failures, Pricing Service at times provided clients with prices that were inconsistent with the nature of, and that did not reasonably reflect the value of, certain securities.

The SEC's order finds that Pricing Service failed to adopt and implement written policies and procedures reasonably designed to prevent violations of the Investment Act and its rules. Without admitting or denying the findings, Pricing Service agreed to cease and desist from future violations of the charged provision, to a censure, and to pay an eight-million-dollar penalty.

SEC Brings Another Mutual Fund Share Class Selection Case

On December 15, 2020, the SEC charged Tennessee-based registered investment adviser CapWealth Advisors, LLC, its principal ("Principal"), and an advisory representative ("Representative"), in connection with their mutual fund share class selection practices. The SEC's complaint alleges that, from at least June 2015 until June 2018, CapWealth, Principal, and Representative violated the Advisers Act by failing to adequately disclose conflicts of interest arising from their selection of mutual fund share classes that charged 12b-1 fees. According to the allegations in the complaint, those 12b-1 fees were paid to an affiliated broker-dealer under common ownership and control with CapWealth, which in turn paid some of the fees directly to Representative as compensation, and indirectly to Principal, through his majority stake in CapWealth's holding company. In addition, the complaint alleges that CapWealth, Principal, and Representative breached their duty to seek best execution for their clients' mutual fund share class purchases by causing certain advisory clients to invest in fund share classes that charged 12b-1 fees when share classes of the same funds that presented a more favorable value for the clients were available. According to the complaint, CapWealth also failed to adopt and implement written policies and procedures designed to prevent these violations.

CapWealth was eligible to self-report to the SEC pursuant to the Division of Enforcement's Share Class Selection Disclosure Initiative, but did not do so. The SEC seeks financial penalties against CapWealth, Principal, and Representative, as well as disgorgement of ill-gotten gains plus prejudgment interest from Principal and Representative.

SEC Charges Brokerage Firm with Misleading Customers About Revenue Sources and Failing to Satisfy Best Execution Duty

On December 17, 2020, the SEC charged a discount brokerage firm offering commission-free trading through its website and mobile app ("Brokerage Firm") with repeated misstatements that failed to disclose the receipt of payments from trading firms for routing customer orders to them, and with failing to satisfy its duty to seek the best reasonably available terms to execute customer orders. According to the SEC's order, the Brokerage Firm made misleading statements and omissions in customer communications when describing how it made money and failed to disclose payments it received from the trading firms. As the SEC's order finds, one of the Brokerage Firm's selling points to customers was that trading was "commission free," but due in large part to its unusually high payment for order flow rates, the orders of Brokerage Firm customers were executed at prices that were inferior to other brokers' prices. Despite this, according to the SEC's order, the Brokerage Firm falsely claimed that its execution quality matched or beat that of its competitors. The order found that the Brokerage Firm deprived customers of $34.1 million, even after taking into account the savings from not paying a commission.

Without admitting or denying the SEC's findings, the Brokerage Firm agreed to a cease-and-desist order prohibiting it from violating the antifraud and recordkeeping provisions of the federal securities law, censuring it, and requiring it to pay a $65 million civil penalty. The Brokerage Firm also agreed to retain an independent consultant to review its policies and procedures relating to customer communications, payment for order flow, and best execution of customer orders, and to ensure that the Brokerage Firm is effectively following those policies and procedures.

SEC Charges Corporation and Two Executives with Conducting $1.3 Billion Unregistered Securities Offering

On December 22, 2020, the SEC announced that it filed an action against a corporation ("Corporation") and two of its executives, who are also significant security holders, alleging that they raised over $1.3 billion through an unregistered, ongoing digital asset securities offering. The complaint alleges that Corporation raised funds through the sale of digital assets known as XRP in an unregistered securities offering to investors in the U.S. and worldwide. Corporation also allegedly distributed billions of XRP in exchange for non-cash consideration, such as labor and market-making services. According to the complaint, the executives also effected personal unregistered sales of XRP totaling approximately $600 million. The complaint alleges that the defendants failed to register their offers and sales of XRP or satisfy any exemption from registration, in violation of the registration provisions of the federal securities laws. The SEC's complaint, filed in federal district court in Manhattan, charges defendants with violating the registration provisions of the federal securities laws, and seeks injunctive relief, disgorgement with prejudgment interest, and civil penalties.

SEC Obtains Emergency Asset Freeze, Charges Crypto Fund Manager with Alleged Fraud

On December 28, 2020, the SEC announced that it filed an emergency action and obtained an order imposing an asset freeze and other emergency relief against a limited liability company ("LLC") and its affiliated companies in connection with an alleged securities fraud relating to LLC's flagship cryptocurrency trading fund (the "Fund"). The SEC's action alleges that the fraud was directed by an Australian citizen and part-time resident of New York who owns and controls the LLC and its affiliated companies ("Adviser").

According to the complaint, filed in the Southern District of New York, Adviser and his entities have been defrauding investors in the Fund since at least 2018, by making material misrepresentations about the Fund's strategy, assets, and financial condition. The complaint alleges that the defendants misled investors to believe their money was being used solely for cryptocurrency trading based on a proprietary algorithm, while Adviser and his entities used investment proceeds for personal purposes or for other undisclosed high-risk investments. The complaint states that since at least July 2020, Adviser and LLC have told investors who requested redemptions from the Fund that their interests would be transferred instead to another fund under the ultimate control of Adviser but with separate management and operations. The complaint alleges that no funds were transferred, and the redemption requests remain outstanding. The complaint further alleges that Adviser is actively attempting to raise new investments in the Fund by misappropriating assets from

another fund under the ultimate control of Adviser but with separate management and operations.

The SEC's complaint charges Adviser, LLC, and other affiliated companies with violations of the antifraud provisions of the federal securities laws, and seeks permanent injunctions, including conduct-based injunctions, disgorgement with pre-judgment interest, and civil penalties.

Excessive Fee Litigation Case Dismissed

On December 30, 2021, a Joint Stipulation of Dismissal with Prejudice was filed in *Zoidis et. al. v. T. Rowe Price Associates, Inc.* (Case No. GLR-16-2786). Plaintiffs in the case, which was originally filed in California federal court on April 27, 2016, alleged that T. Rowe Price violated its fiduciary duty with respect to the receipt of compensation under Section 36(b) of the 1940 Act by overcharging investment management fees, which over the years had doubled despite the fact that there was no increase in the actual services performed by the investment manager. The complaint alleged that T. Rowe charged excessive fees on eight funds compared to what it charged to subadvise unaffiliated funds using the same strategies at other complexes. The Complaint alleged that T. Rowe Price's board, who annually approves the investment management fees, did not specifically assess the fees presented to them nor did they look at each fund's peer group to confirm that the fees being charged were reasonable.

The action was dismissed with prejudice, and the parties stipulated that the dismissal was not the result of a settlement, compromise, or payment of any consideration to plaintiffs. The T. Rowe case was the last excessive fee litigation based on the subadvisory fee comparison theory pending trial, out of the 29 complaints that have been filed since 2010. Its dismissal indicates that excessive fee litigation based on this theory, which have been pursued without success, could be coming to an end.

SEC Charges Real Estate Fund Manager with Misappropriating Over $7 Million From Retail Investors

On January 12, 2021, the SEC charged a fund manager ("Manager") and his company ("Company") with defrauding retail investors in two real estate funds managed by Company. According to the SEC's complaint, Manager, a licensed real estate broker with no investment management experience, and Company, raised a total of $58 million primarily on the strength of a fabricated investment track record. The complaint alleges that in marketing the funds, Company and Manager falsely claimed that they had previously managed two highly-successful real estate funds. As alleged, Manager and Company made numerous other misrepresentations in their marketing materials and offering documents, including claiming that investors' capital was secured by a non-existent $250 million balance sheet and that they had partnerships with hundreds of prospective tenants with pre-signed, multi-year lease agreements. Finally, the complaint alleges that Company and Manager misappropriated more than $7 million in investor assets while using falsified financial reports to conceal huge losses that ultimately forced the two funds to dissolve. The SEC's complaint, filed in U.S. District Court for the Southern District of New York, charges Company and Manager with violations of the antifraud provisions of the federal securities laws. The SEC seeks injunctive relief, civil penalties, and disgorgement of ill-gotten gains plus prejudgment interest.

Whistleblower Awards Surpass Record Amounts

There have been several significant whistleblower awards in the past several months. On October 22, 2020, the SEC announced an award of over $114 million to a whistleblower, marking the highest award in the program's history. Most recently, on January 14, 2021, the SEC announced an award of nearly $600,000. Since October 2020, the SEC has awarded 28 individuals over $176 million in whistleblower awards, surpassing the total dollar amount awarded in the entirety of any prior fiscal year. The SEC has awarded more than $738 million to 134 individuals since issuing its first award in 2012.

Thomas R. Westle *and* ***Stacy H. Louizos*** *would like to thank* ***Margaret M. Murphy*** *and* ***Jennifer Patt*** *for their contributions to this update.*

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