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Investment Management

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Q4 Regulatory Update

RECENT SEC ADMINISTRATION CHANGES

SEC Chair Gensler to Depart Agency on January 20

The Securities and Exchange Commission (the "SEC") announced, on November 21, 2024, that its Chair, Gary Gensler, will step down. Chair Gensler's resignation from the SEC will be effective at 12:00 pm EST on January 20, 2025. On December 4, 2024, President-elect Trump stated his intention to nominate Paul Atkins as the Chair of the SEC. Mr. Atkins served as a Commissioner from 2002 to 2008 and on the SEC staff in the 1990s.

SEC Announced Departure of Trading and Markets Division Director

The SEC, on December 9, 2024, announced that Haoxiang Zhu, Director of the Division of Trading and Markets, would depart the agency effective December 10, 2024. David Saltiel, a Deputy Director who also heads the Division of Trading and Markets Office of Analytics and Research, will serve as Acting Director. Mr. Saltiel served as the Division of Trading and Markets Acting Director for several months in 2021.

SEC Announces Departure of Corporation Finance Division Director

The SEC, on December 13, 2024, announced that Erik Gerding, Director of the Division of Corporate Finance, would depart the agency effective December 31, 2024. Cicely LaMothe is now the Acting Director. Ms. LaMothe previously served as the Deputy Director, Disclosure Operations for the Division of Corporation Finance. Before joining the SEC, Ms. LaMothe worked in the private sector for six years, including as the financial reporting manager for a public company and as a senior associate with a national accounting firm.

SEC RULEMAKING

SEC Adopts Rule Amendments and New Rule Addressing Wind-Down Planning of Covered Clearing Agencies

The SEC, on October 25, 2024, announced the adoption of rule amendments and a new rule to improve the resilience and recovery and wind-down planning of covered clearing agencies. The rule amendments establish new requirements regarding a covered clearing agency's collection of intraday margin, as well as its reliance on substantive inputs to its risk-based margin model. The new rule requires a covered clearing agency to specify nine elements for its recovery and wind-down plan that address: (1) the identification and use of scenarios, triggers, tools, staffing, and service providers; (2) timing and implementation of the plans; and (3) testing and board approval of the plans.

SEC Modernizes Submission of Certain Forms, Filings, and Materials Under the Securities Exchange Act of 1934

The SEC, on December 16, 2024, adopted amendments to require the electronic filing, submission, or posting of certain forms, filings, and other submissions that national securities

exchanges, national securities associations, clearing agencies, broker-dealers, security-based swap dealers, and major security-based swap participants make with the SEC. Prior to the adoption of these amendments, registrants filed with, or otherwise submitted to, the SEC many of the forms, filings, or other materials in paper form. Under the amendments, registrants will make these filings and submissions electronically using the SEC's EDGAR system, in structured data format where appropriate, or by posting them online.

SEC Adopts Rule Amendment to Broker-Dealer Customer Protection Rule

The SEC, on December 20, 2024, adopted amendments to Rule 15c3-3 (the "Customer Protection Rule") to require certain broker-dealers to increase the frequency with which they perform computations of the net cash they owe customers and other broker-dealers from weekly to daily. The amendments will become effective 60 days after the date of publication of the adopting release in the Federal Register. Broker-dealers that exceed the $500 million threshold using each of the 12 filed month-end FOCUS Reports from July 31, 2024, through June 30, 2025, must comply with the daily computations no later than December 31, 2025.

SEC ENFORCEMENT ACTIONS AND OTHER CASES

SEC Charges Market Makers and Nine Individuals in Crackdown on Manipulation of Crypto Assets Offered and Sold as Securities

The SEC, on October 9, 2024, announced fraud charges against three companies purporting to be market makers and nine individuals for engaging in schemes to manipulate the markets for various crypto assets. The SEC alleges that the companies provided "market-manipulation-as-a-service" which included generating artificial trading volume through trading practices that served no economic purpose and that they used algorithms (or bots) that, at times, generated "quadrillions" of transactions and billions of dollars of artificial trading volume each day.

SEC Charges Investment Adviser and Owner for Making False and Misleading Statements About Use of Artificial Intelligence

The SEC, on October 10, 2024, announced charges against an investment adviser (the "Adviser") and two individuals, an owner and a director of the Adviser, with making false and misleading claims about the Adviser's purported use of artificial intelligence ("AI") to perform automated trading for client accounts and numerous other material misrepresentations. The SEC's order states that the two individuals raised nearly $4 million from 45 investors for the growth of the Adviser that was falsely described as having an AI-driven platform. The Adviser and individuals were charged with fraudulent conduct in the offer or sale of securities under the Securities Act of 1933 and the Securities Exchange Act of 1934, and the Adviser was charged with fraudulent conduct by an investment adviser under the Investment Advisers Act of 1940, as amended.

SEC Charges Advisory Firm with Failing to Adhere to Own Investment Criteria for ESG-Marketed Funds

The SEC, on October 21, 2024, charged a New York-based investment adviser (the "Adviser") with making misstatements and for compliance failures relating to the execution of the investment strategy of three exchange-traded funds ("ETFs") that were marketed as incorporating environmental, social, and governance ("ESG") factors. According to the SEC's order, the Adviser represented in the prospectuses for the ETFs and to the board of trustees overseeing the ETFs, that the ETFs would not invest in companies involving certain products or activities, such as fossil fuels and tobacco. Further, the SEC order states that the Adviser used data from third-party vendors that did not screen out all companies involved in fossil fuel and tobacco-related activities. The SEC's order further finds that the Adviser did not have any policies and procedures over the screening process to exclude such companies. The Adviser consented to the entry of the SEC's order finding that the firm violated the antifraud provisions of the Investment Advisers Act of 1940 and the Investment Company Act of 1940 and the Compliance Rule of the Investment Advisers Act.

"At a fundamental level, the federal securities laws enforce a straightforward proposition: investment advisers must do what they say and say what they do," said Sanjay Wadhwa, Acting Director of the SEC's Division of Enforcement. "When investment advisers represent that they will follow particular investment criteria, whether that is investing in, or refraining from investing in, companies involved in certain activities, they have to adhere to that criteria and appropriately disclose any limitations or exceptions to such criteria. By contrast, the funds at issue in today's enforcement action made precisely the types of investments that investors would not have expected them to based on the Adviser's disclosures."

Directors of Money Market Fund Sued Over Share Class Conversion

Two shareholders (the "Shareholders") filed a lawsuit alleging that the directors of a money market fund (the "Directors") breached their fiduciary duty by failing to automatically move fund investors' assets from higher cost share classes of the fund to lower-cost share classes. The Shareholders allege that the board of the money market fund allowed certain fund investors to continue paying higher fees as retail class shareholders rather than auto-converting their holdings to the cheaper, but otherwise identical premium class, even though their holdings were eligible for the "auto-conversion". The complaint states that "[the Directors'] inaction demonstrates gross neglect or reckless disregard for the best interest of the class shareholders… Either the [Directors] have been recklessly uninformed of these massive overcharges that cause significant losses to the shareholders, or have known about the issue and inexcusably failed to take action to remedy it." The Shareholders seek damages, restitution, disgorgement, and an injunction preventing the Directors from continuing to engage in the alleged conduct.

Two Entities Affiliated with Major Institutional Organization to Pay $151 Million to Resolve SEC Enforcement Actions

The SEC, on October 31, 2024, charged two affiliated and commonly-owned investment advisers (each an "Adviser" and together, the "Advisers") in five separate enforcement actions for compliance failures including misleading disclosures to investors, breach of fiduciary duty, prohibited joint transactions and principal trades, and failures to make recommendations in the best interest of customers. The enforcement actions related to:

1. *Conduit Private Funds* – An Adviser made misleading statements regarding its ability to exercise discretion over when to sell and the number of shares to be sold, despite disclosures representing that it had no discretion.
2. *Portfolio Management Program* – An Adviser failed to fully and fairly disclose the financial incentive that the firm and some of its financial advisors had when they recommended the Adviser's own Portfolio Management Program over third-party managed advisor programs offered by the Adviser.
3. *Clone Mutual Funds* – An Adviser recommended certain mutual fund products, Clone Mutual Funds, to its retail brokerage customers when materially less expensive ETF products that offered the same investment portfolios were available.
4. *Joint Transactions* – An Adviser engaged in $3.4 billion worth of prohibited joint transactions, which advantaged an affiliated foreign money market fund for which it served as the delegated portfolio manager over three U.S. money market mutual funds it advised.
5. *Principal Trades* – An Adviser engaged in or caused 65 prohibited principal trades with a combined notional value of approximately $8.2 billion. In order to conduct these transactions, according to the SEC's order, a portfolio manager directed an unaffiliated broker-dealer to buy commercial paper or short-term fixed income securities from the Adviser which the other Adviser then purchased on behalf of one of its clients.

SEC Charges Adviser for Making Misleading Statements About ESG Integration

The SEC, on November 8, 2024, charged an investment adviser (the "Adviser") with making misleading statements about the percentage of company-wide assets under management that integrated ESG factors. The Adviser stated in marketing materials that between 70 percent and 94 percent of its parent company's assets under management were "ESG integrated." However, in reality, these percentages included a substantial amount of assets that were held in passive ETFs that did not consider ESG factors. Furthermore, the SEC's order found that the Adviser lacked any written policy defining ESG integration.

SEC Charges Three Broker-Dealers with Filing Deficient Suspicious Activity Reports

The SEC, on November 22, 2024, announced that three broker-dealers (the "Broker-Dealers") agreed to settle charges relating to deficient suspicious activity reports ("SARs") filed by the Broker Dealers. The SEC alleged that multiple SARs filed by the Broker-Dealers failed to include important, required information. SARs must contain "a clear, complete, and concise description of the activity, including what was unusual or irregular" that caused suspicion of the use of funds derived from illegal activity or activity that has no apparent lawful purposes. The SEC's orders alleged that each Broker-Dealer filed multiple deficient SARs over a four-year period.

SEC Charges Former Chief Investment Officer with Fraud

The SEC, on November 25, 2024, charged the former co-chief investment officer (the "CIO") of a registered investment adviser with engaging a multi-year scheme to allocate favorable trades to certain portfolios, while allocating unfavorable trades to other portfolios (also known as "cherry-picking"). The SEC's complaint alleges that the CIO

would place trades with brokers but wait until later in the day to allocate the trades among clients in the portfolios he managed. According to the complaint, the CIO's delay in allocating the trades allowed him to allocate trades at first-day gains to favored portfolios and trades at first-day losses to disfavored portfolios.

SEC Charges Wealth Management Company for Policy Deficiencies Resulting in Failure to Prevent and Detect Financial Advisors' Theft of Investor Funds

The SEC, on December 9, 2024, charged a wealth management company (the "Company") with (1) failing to reasonably supervise four investment advisers and registered representatives (the "Financial Advisers") who stole millions of dollars of advisory clients' and brokerage customers' funds and (2) failing to adopt policies and procedures reasonably designed to prevent and detect the theft. Specifically, the SEC found that the Company failed to adopt and implement policies designed to prevent the Financial Advisers from using two forms of unauthorized third-party disbursements, Automated Clearing House payments and certain patterns of cash wire transfers, to misappropriate funds from client accounts.

SEC Charges Two Broker-Dealers with Recordkeeping and Reporting Violations for Submitting Deficient Trading Data to SEC

The SEC, on December 20, 2024, announced settled charges against two broker-dealers (each a "Broker-Dealer" and together, the "Broker-Dealers"). According to the SEC's order, the Broker Dealers made numerous blue sheet submissions to the SEC that contained various deficiencies, including inaccurate or missing information about securities transactions and the firms or customers involved in the transactions. The SEC found that, one of the Broker-Dealers made 15 types of errors, that caused nearly 11,200 blue sheet submissions to have missing or inaccurate data for at least 10.6 million total transactions, while the other Broker-Dealer made 10 types of errors that caused 3,700 blue sheet submissions to have misreported or missing data for nearly 400,000 transactions.

International Bank Subsidiary to Pay $4 Million for Untimely Filing of Suspicious Activity Reports

The SEC, on December 20, 2024, charged a registered broker-dealer (the "Broker-Dealer") for failing to file certain SARs in a timely manner. According to the SEC's order, the Broker-Dealer received requests in connection with law enforcement or regulatory investigations, or litigation that prompted it to conduct SARs investigations. The SEC's order found that in certain instances, the Broker-Dealer failed to conduct or complete the investigations within a reasonable period of time.

SEC Files Settled Charges Against Multiple Entities for Failing to Timely File Form D in Connection with Securities Offering

The SEC, on December 20, 2024, announced charges against three companies (for this section only, the "Companies") for failing to timely file Forms D for several unregistered securities offerings in violations of Rule 503 of Regulation D of the Securities Act of 1933. The SEC found that one of the Companies, a registered investment adviser that controls two private funds, failed to ensure that such private funds timely filed Forms D in connection with offerings involving the sale of membership interest in such private funds. The SEC found that two other Companies, both privately held companies, failed to timely file Forms D in connection with unregistered securities offerings for which the Companies engaged in certain communications that constituted general solicitations.

"Form D filings are crucial sources of information on private capital formation, and compliance with the requirement to make such filings in a timely manner is vital to the Commission's efforts to promote investor protection while also facilitating capital formation, especially with respect to small businesses," said Sanjay Wadhwa, Acting Director of the SEC's Division of Enforcement. "Today's orders find that the charged entities deprived the Commission and the marketplace of timely information concerning nearly $300 million of unregistered securities offerings."

Shareholders File Derivative Complaint Against Independent Directors and Fund Management Alleging Breach of Fiduciary Duties

In December 2024, a derivative complaint was filed against the independent directors and fund management, alleging that their breach of fiduciary duties was responsible for the "astonishing collapse" of several funds. In December 2021, the board of directors (the "Board") approved a plan of liquidation involving transferring nearly all the $300 million

in assets of four closed-end feeder funds and a master fund, along with several private funds, for unlisted preferred units from the buying company (the "Buyer"). Ultimately, the units converted into common shares worth eight dollars each when the Buyer went public through a merger with a special purpose acquisition company. Since going public, the value of the shares has fallen to 81 cents, or less than a penny after accounting for a one-for-80 reverse stock split. According to the lawsuit, fund management and the Board did not inform the shareholders of the liquidation plan until weeks after it happened, and the liquidation plan was never submitted to shareholders for approval.

OTHER INDUSTRY HIGHLIGHTS

SEC Division of Examinations Announces its Examination Priorities for Fiscal Year 2025

The SEC Division of Examinations (the "Division"), on October 1, 2024, published its Fiscal Year 2025 Examination Priorities which highlights the practices, products, and services that the Division of Examinations believes present heightened risk to investors or the overall integrity of U.S. capital markets. The report indicated that the Division would focus on:

Investment Advisers – (1) adherence to fiduciary standards of conduct, (2) effectiveness of advisers' compliance programs, and (3) examinations of advisers to private funds.

Investment Companies – (1) fund fees and expenses, and any waiver or reimbursements, (2) oversight of service providers (both affiliated and third-party), (3) portfolio management practices and disclosures, for consistency with claims about investment strategies or approaches and with fund filings and marketing materials, and (4) issues associated with market volatility.

The report also indicated that the Division is going to continue examining advisers and funds that have never been examined or those that have not been examined recently, with a particular focus on newly registered funds. The full report can be found here.

SEC Announced Enforcement Results for Fiscal Year 2024

The SEC announced that it filed a total of 583 enforcement actions in fiscal year 2024 while obtaining orders for $8.2 billion in financial remedies. The 583 enforcement actions represent a 26 percent decline in total enforcement actions compared to fiscal year 2023. Key areas of focus by the SEC included:

1. *Off-channel communications.* In fiscal year 2024, the SEC brought recordkeeping cases against more than 70 firms resulting in more than $600 million in civil penalties.
2. *Marketing Rule (Rule 206(4)-1 under the Investment Advisers Act of 1940, as amended (the "Advisers Act")) compliance.* More than a dozen investment advisers were charged with non-compliance of the Advisers Act Marketing Rule including charges for advertising hypothetical performance to the general public without implementing policies and procedures reasonably designed to ensure hypothetical performance was relevant.
3. *Misleading claims regarding AI.* AI and other emerging technologies presented heightened investor risk from market participants using social media to exploit elevated investor interest in emerging investment products and strategies. These actions included multiple actions against advisers alleging the use AI in their investment processes.

SEC Risk Alert Highlights Examination Deficiencies Found in Core Focus Areas for Registered Investment Companies

The SEC's Division of Examinations (the "Staff" or the "Division") issued a risk alert (the "Alert") regarding its review of certain core focus areas and associated document requests for registered investment companies (each a "Fund", and collectively, the "Funds"). The Alert highlighted that examinations typically focus on whether Funds: (1) have adopted and implemented effective written policies and procedures to prevent violation of the federal securities laws and regulations, (2) provided clear and accurate disclosures that are consistent with their practices, and (3) promptly addressed compliance issues, when identified.

The Staff reviewed deficiency letters sent to Funds during the most recent four-year period and analyzed deficiencies and weakness related to the core areas of fund compliance programs, disclosures and filings, and governance practices. Below are some of the common deficiencies:

Fund Compliance Programs

- Funds did not perform required oversight or reviews as stated in their policies and procedures or perform required assessments of the effectiveness of their compliance programs.
- Funds did not adopt, implement, update, and/or enforce policies and procedures.
- Policies and procedures were not tailored to the Funds' business models or were incomplete, inaccurate, or inconsistent with actual practices.
- Funds' Codes of Ethics were not adopted, implemented, followed, enforced, or did not otherwise appear adequate.
- Chief Compliance Officers did not provide requisite written annual compliance reports to Fund boards.

Fund Disclosures and Filings

- Fund registration statements, fact sheets, annual reports, and semi-annual reports contained incomplete or outdated information or contained potentially misleading statements.
- Sales literature, including websites, appeared to contain untrue statements or omissions of material fact.
- Fund filings were not made or were not made on a timely basis.

Fund Governance Practices

- Fund board approvals of advisory agreements appeared to be inconsistent with the requirements of the Investment Company Act of 1940, as amended, and/or the Funds' written compliance procedures.
- Fund boards did not receive certain information to effectively oversee Fund practices.
- Fund boards did not perform required responsibilities.
- Fund board minutes did not fully document board actions.

The full alert can be accessed here.

SEC's Division of Investment Management's Disclosure Review and Accounting Office Identifies Common Issues Found in Review of Tailored Shareholder Reports

As of July 24, 2024, open-end funds have been required to file more concise annual and semi-annual reports ("Tailored Shareholder Reports" or "TSRs") that highlight information that the SEC deems "particularly important" to retail shareholders in assessing and monitoring their fund investments. After three months of TSR filings, on November 8, 2024, the Division of Investment Management's Disclosure Review and Accounting Office ("DRAO"), which is responsible for reviewing TSR filings, published Accounting and Disclosure Information 2024-14 (the "ADI") which flags common issues it has identified in its review of TSR filings and provides a reminder to funds of certain requirements.

Issues Regarding Expense Information

- Annualizing expenses in dollars paid on a $10,000 investment in a semi-annual shareholder report, instead of reflecting the dollar costs over the period on a non-annualized basis.
- Calculating expenses in dollars paid on a $10,000 investment by incorrectly multiplying the "Costs paid as a percentage of your investment" by $10,000, instead of multiplying the figure in the "Cost paid as a percentage of your investment" column by the average account value over the period based on an investment of $10,000 at the beginning of the period.
- Presenting expenses in dollars paid on $10,000 investments to the nearest cent, when the figure must be rounded to the nearest dollar.
- Funds might consider noting in their semi-annual reports that costs paid as a percentage of a $10,000 investment is an annualized figure.

Issues Regarding Management's Discussion of Fund Performance

- Disclosure by many ETFs of average annual total returns for the past one-, five-, and 10-year periods based on market value, instead of the ETF's net asset value; additional disclosure of market value performance is not permitted to be included in the shareholder reports.
- Failure by some funds to compare their performance to an appropriate broad-based securities market index both in their shareholder reports and in its prospectus.
- Failure by some funds to include a statement to the effect that past performance is not a good predictor of the fund's future performance, or to utilize text features to make the statement noticeable and prominent.

Other Issues

- Including portfolio-level statistics, such as average maturity or average credit rating, under the heading "Graphical Representations of Holdings," instead of under the heading "Fund Statistics."
- Disclosing holdings as a percentage without specifying the basis for the presentation of the information (i.e., net asset value, total investments, or total or net exposure).

- Disclosing material fund changes while omitting the required cover page disclosure or including the cover page disclosure but failing to include any disclosure about the material fund changes.
- Including broken links (to their websites) in their shareholder reports.
- Including extraneous and sometimes lengthy disclosures such as disclaimers or risks that are not required or permitted.
- For Inline XBRL structured data purposes, tagging all of their indexes as broad-based indexes instead of tagging their additional indexes with the separate tag intended for additional indexes.

For further information, the complete ADI may be accessed, here.

For additional information or assistance, contact Thomas R. Westle, Stacy H. Louizos, or another member of Blank Rome's Investment Management Group.

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