Simpson Thacher

Registered Funds Regulatory Update

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SEC Rulemaking

SEC Proposes Mandatory Swing Pricing Framework

The SEC voted to propose amendments to the liquidity risk management rule (Rule 22e-4 under the 1940 Act) and other related amendments to address alleged weaknesses in liquidity risk management programs for open-end funds (*e.g.*, mutual funds and ETFs) and to seek to prevent potential share dilution. The proposal would not apply to closed-end funds and BDCs, including interval funds and tender offer funds, since such funds are not subject to Rule 22e-4. The proposal comes in response to the liquidity concerns that arose during the March 2020 market volatility and targets two main areas: liquidity classifications and swing pricing.

Liquidity Classifications. The proposal would amend liquidity classification requirements for open-end funds, other than money market funds and certain ETFs. The current approach to liquidity classification requires a fund to classify its investments into one of four liquidity categories, or "buckets"—highly liquid, moderately liquid, less liquid, and illiquid. The liquidity classification is based on the number of days it would take to convert an investment into cash, in a "reasonably anticipated trade size," without significant changes to the investment's market value (the "value impact").

The proposed amendments would change this framework in several significant ways. First, the amended rule would require funds to classify the liquidity of an investment by measuring the number of days in which the investment is reasonably expected to be convertible to U.S. dollars without significantly changing the market value of the investment, while assuming the sale of 10% of the fund's net assets by reducing each investment by 10%.

Second, the proposed amendments would define the value impact standard with more specificity as to when a sale or disposition would significantly change the market value of an investment. Under the current rule, a fund may determine value impact in a variety of ways, depending on the type of asset, vendor, model, or system used. The proposed definition of a significant change in market value would require a fund to consider the size of the sale relative to the depth of the market for the instrument, which would vary depending on the type of investment. For shares listed on an exchange, for example, the sale or disposition of more than 20% of the security's average daily trading level (measured over the preceding 20 business days) would constitute a significant change in that security's market value. For investments other than shares listed on an exchange, any sale or disposition that is reasonably expected to decrease the sale price more than 1% would constitute a significant change in market value.

The proposed amendments would also prohibit funds from classifying investments according to their asset class and would increase the frequency of these liquidity classifications from monthly to daily. In the proposing release, the SEC claimed asset class-level classifications are not widely used by many funds, noting that such

classifications run the risk of over-estimating the liquidity of a fund's investments. Instead, the proposed amendments would require a fund to classify each individual investment according to its liquidity characteristics. For funds that invest in dozens if not hundreds of securities and currently engage in asset class-level classifications on a monthly basis, the proposed changes could impose a consequential administrative burden.

In another significant change, the proposed amendments would eliminate the bucket for "less liquid" investments thereby reducing the number buckets from four to three. These investments that a fund reasonably expects not to be convertible to U.S. dollars in seven calendar days or less without significantly changing their market value would instead be treated as illiquid investments under the proposed amendments. For open-end funds that invest heavily in less liquid investments, such as bank loan funds, this change could require the fund to convert to a closed-end fund structure or change its investment strategy given that open-end funds are restricted from investing more than 15% of their assets in illiquid investments.

The amendments would also require funds to maintain a minimum of 10% of net assets in highly liquid investments. Finally, the proposed amendments make several adjustments to the definitions of liquidity classification categories and related terms, including an expansion of the term "illiquid investment" to include any investment whose fair value is measured using an unobservable input that is significant to the overall measurement.

Swing Pricing. Another controversial aspect of the proposal would amend Rule 22c-1 under the 1940 Act to mandate swing pricing for all open-end funds other than money market funds and ETFs, despite the industry consistently providing feedback that swing pricing is not operationally feasible. Swing pricing is currently optional, and no funds have elected to implement swing pricing since the current rule's implementation.

Under the proposed amendments, funds would need to adjust a fund's NAV by a "swing factor" when experiencing net redemptions or net purchases in excess of 2% of net assets. In determining the swing factor price adjustment, a fund would be required to make good faith estimates of the transaction costs of selling or purchasing a *pro rata* amount of its portfolio investments to satisfy that day's redemptions or to invest the proceeds from that day's purchases. The good faith estimate must include spread costs, brokerage commissions, custody fees, and any other fees associated with portfolio investment sales. Additionally, if net redemptions exceed 15% of assets, a fund would also be required to include market impact costs in its swing factor. The proposed rule includes additional guidance for estimating the market impact. Furthermore, funds would have to report publicly their swing factor adjustments on Form N-PORT.

The proposal would also establish a "hard close," which the SEC believes would aid in the operational implementation of swing pricing by providing funds with more adequate order flow information. Specifically, orders for purchases or redemptions would be eligible for that day's price only if the order is received by the fund, transfer agent or clearing agency before the time as of which the fund calculates its NAV, typically 4:00 p.m. Alternatively, intermediaries could, as a matter of practice, choose to process orders at the next day's price. The

SEC's proposed "hard close" rule could have significant practical implications for intermediaries, who would likely need to make extensive changes to their business practices to ensure that order flow information is received before 4:00 p.m. The intermediary and retirement plan channels, in particular, would be significantly impacted by the proposed changes because they frequently do not transmit order flow details to a fund's transfer agent or the clearing agency until after a fund has calculated its daily NAV and publicly disseminated the NAV. This would require certain intermediary channels to submit orders earlier in the day that then could be negatively impacted by market events prior to the 4:00 p.m. close.

Form N-PORT. In connection with the two categories of changes above, the proposed rule would require more frequent and expansive reporting. Form N-PORT would be amended to require public reporting of aggregate liquidity classifications as well as frequency and amount of swing pricing adjustments. Funds would also be required to file monthly reports within 30 days after month-end, which would become public 60 days after month-end.

Comments on the proposal are due 60 days after the release is published in the Federal Register.

Open-End Fund Liquidity Risk Management Programs and Swing Pricing; Form N-PORT, SEC Release Nos. 33-11130; IC-34746 (Nov. 2, 2022), available at: https://www.sec.gov/rules/proposed/2022/33-11130.pdf.

SEC Proposals Aim to Tackle Adviser Oversight of Service Providers

Background

In a split 3-2 vote on October 26, 2022, the SEC proposed an expanded oversight framework for advisers that outsource certain services or functions to service providers. Advisers are currently required under Rule 206(4)-7 under the Advisers Act to have policies and procedures reasonably designed to prevent violations of the Advisers Act and rules thereunder. According to the SEC, the proposed framework seeks to minimize systemic risks resulting from increasing outsourcing of advisory services or functions to service providers. The SEC acknowledged the evolution of the asset management industry over time, noting that many investment advisers provide full service wealth management and financial planning services and use electronic systems to provide those services and maintain records. Moreover, investment products, such as derivatives and ETFs, have evolved over time as well. At the same time, fee pressures for advisers have increased resulting in many advisers engaging service providers to perform certain processes and/or functions (*e.g.*, investment research and data analytics, trading and risk management, and compliance).

Scope of Proposed Rule

New proposed Rule 206(4)-11 under the Advisers Act would, among other things, require advisers to conduct due diligence before outsourcing "covered functions" to service providers and would require extensive recordkeeping

related to such diligence. A "covered function" is defined, as proposed, as a function or service that: (i) is necessary to provide advisory services in compliance with the federal securities laws, and (ii) if not performed or performed negligently, would be reasonably likely to cause a material negative impact on the adviser's clients or on the adviser's ability to provide investment advisory services. Clerical, ministerial, utility, and general office functions or services would be explicitly excluded from the proposed rule.

Under the proposal, the term "service provider" is defined as a person or entity that: (i) performs one or more covered functions; and (ii) is not a supervised person of the adviser since such persons are already being directly overseen by the adviser. Notably, however, the proposal does not distinguish between third-party providers and affiliated service providers because, according to the SEC, the risks that the proposed rule are designed to address exist whether the service provider is affiliated or unaffiliated. The proposed rule also does not exclude service providers that are subject to other provisions of the Advisers Act, including SEC-registered advisers (*e.g.*, sub-advisers), or other Federal securities laws.

Before retaining a service provider, an adviser would be required to "reasonably identify and determine through due diligence" that outsourcing the covered function to that service provider would be "appropriate" by considering: (i) the nature and scope of the covered function; (ii) potential risks resulting from the service provider performing the covered function, including how to mitigate and manage such risks; (iii) the service provider's competence, capacity, and resources necessary to perform the covered function; (iv) the service provider's material subcontracting arrangements related to the covered function; (v) coordination with the service provider for federal securities law compliance; and (vi) the orderly termination of the performance of the covered function. The adviser would be required to periodically monitor each service provider's performance and reassess whether to retain such service provider.

Reporting Requirements

In addition, amendments to Form ADV would require extensive, census-type disclosure regarding in-scope service providers, including whether the service provider is a related person of the adviser, the date the service provider was first engaged to provide a covered function, and a check-the-box exercise through which advisers would disclose the category of covered function performed by the service provider.

ICI Comments

The ICI submitted a comment letter recommending that the SEC scrap the proposal. The ICI stated that the proposed rule is unnecessary because advisers' fiduciary duties and other legal requirements already provide an appropriate legal framework for service provider oversight. In addition, the comment letter stated that the proposed rule is inappropriate and exceeds the SEC's rulemaking authority. The comment letter also pointed to a lack of evidence supporting the new rule and an inadequate analysis of the costs and benefits and suggested that the SEC develop more information about the relationship between advisers and their service providers if it determines to proceed with rulemaking.

Outsourcing by Investment Advisers, SEC Release No. IA-6176 (Oct. 26, 2022), available at: https://www.sec.gov/rules/proposed/2022/ia-6176.pdf; Comment Letter of the Investment Company Institute Re: Outsourcing by Investment Advisers; File No. S7-25-22 (Dec. 23, 2022), available at: https://www.sec.gov/comments/s7-25-22/s72522-20153499-320873.pdf.

SEC Adopts Amendments to Mutual Fund and ETF Shareholder Report Requirements

On October 26, 2022, the SEC adopted amendments to the mutual fund and ETF disclosure framework for shareholder reporting with the goal of streamlining disclosure and better customizing disclosure to retail investor needs. The rule amendments apply only to open-end funds registered on Form N-1A. According to the SEC, the new form items are designed to make the reports more user-friendly and interactive and highlight important information for retail shareholders as they assess and monitor their fund investments.

New Structure and Delivery Requirements. The new shareholder report structure seeks to extend the SEC's "layered approach" to disclosure by tailoring the disclosure to the informational needs of the investor. New Item 27A of Form N-1A only contains what the SEC believes to be the most important information, similar in concept to a summary prospectus. Much of the information that is currently included in a shareholder report will now only be available on the fund's website and Form N-CSR. In addition, the SEC is encouraging funds to use, as appropriate, a question-and-answer format, charts, graphs, tables, bullet lists, and other graphics or text features. Under the final rule, a shareholder report may not incorporate information by reference and must include instructions on how to access additional information about the fund if desired.

The amended shareholder report structure also requires that a report only contain information for one fund and one specific class of that fund, which is a significant departure from current practice. The new shareholder report can direct shareholders to the fund's website to access information showing multiple share classes.

In a departure from Rule 30e-3 under the 1940 Act, which allows funds to provide notice and access to shareholder reports on the fund's website rather than directly mailing the full report to each shareholder, the final rule requires a fund to mail the new summary shareholder report to each shareholder. While managers commented on the additional costs to mail shareholder reports, the SEC stated that the new summary format would cut mailing costs and improve the likelihood that shareholders have access to material information related to their investments.

New Content Requirements

The final rule limits the scope of shareholder reports, allowing only information that new Item 27A specifically permits or requires. Thus, reports may no longer include a president's letter, market commentary, or portfolio manager commentary, and the management discussion of fund performance, or "MDFP," should be limited to a

short summary of key facts. In addition, other items formerly included in the shareholder report, such as financial highlights and financial statements, portfolio holdings, matters submitted to shareholder vote, Section 15(c) contract approval disclosure, and director and officer compensation, will instead be included on the fund's website and Form N-CSR.

The tailored report must include a description of any material fund changes, including a discussion of whether the change affects the management of the fund, its risk profile, or whether a shareholder would choose to invest in the fund. The SEC stated that it does not consider portfolio manager changes material unless the fund considers it a material change (*e.g.*, if the portfolio manager is well known in the industry and prominently advertised). On the other hand, fee changes generally are material, as are material disagreements with a fund accountant that trigger Regulation S-K Item 304(a). The report can instruct shareholders that additional information is available on the fund's website, but it must facilitate access to that material by means of a hyperlink, QR code, or similar method.

Tailored Shareholder Reports for Mutual Funds and Exchange-Traded Funds; Fee Information in Investment Company Advertisements, SEC Release No. IC-34731 (October 26, 2022), available at: https://www.sec.gov/rules/final/2022/33-11125.pdf.

SEC Updates Advertising Rules for Investment Companies and BDCs

On October 26, 2022, the SEC adopted amendments to Rules 482, 156, and 433 under the Securities Act and Rule 34b-1 under the 1940 Act, which address investment company fee and expense presentations in advertisements. The final rule amendments affect all registered investment company and BDC advertisements that include fee and expense figures and require that presentations of investment company fees and expenses in advertisements and sales literature be consistent with relevant prospectus fee table presentations and be reasonably current.

More specifically, the amendments to Rule 482 will require all fee or expense figures in advertisements to be presented in a standardized manner and in adherence with certain prominence and timeliness requirements. Advertisements providing fee and expense figures must include: (i) the maximum amount of any sales load or any other nonrecurring fee; (ii) gross total annual expenses, computed in a manner that is consistent with relevant prospectus requirements; and (iii) if a fund has a fee waiver or expense reimbursement arrangement in effect, the termination date of any such arrangement. Under the amendments, advertisements may include other figures related to an investment company's fees and expenses; however, the required fee and expense figures will have to be presented at least as prominently as any other figure. Fee and expense information contained in an advertisement must be as of the date of the fund's most recent prospectus or, if the fund no longer has an effective registration statement, as of the date of its most recent annual shareholder report. A fund may provide more current information if available.

Instead of relying on Rule 482, BDCs and registered closed-end funds may continue to use free writing prospectuses in accordance with Rule 433 and certain other SEC rules for advertising purposes. Rule 433 was amended to incorporate the prominence and timeliness requirements of Rule 482 related to the presentation of fee and expense figures.

The SEC amended Rule 156 to state that "representations about the fees or expenses associated with an investment in an investment company could be misleading because of statements or omissions made involving a material fact, including situations where portrayals of the fees and expenses associated with an investment in the fund omit explanations, qualifications, limitations, or other statements necessary or appropriate to make the portrayals not misleading." The SEC explained that representing a particular investment company as a "zero expense" or "no expense" fund, without mentioning other costs an investor may incur when investing in that fund, may be misleading under amended Rule 156. However, consistent with current Rule 156, an analysis of whether a representation is materially misleading will depend on the context in which it is made.

The SEC imposed an 18-month transition period for funds to come into compliance with the new amendments.

Tailored Shareholder Reports for Mutual Funds and Exchange-Traded Funds; Fee Information in Investment Company Advertisements, SEC Release No. IC-34731 (Oct. 26, 2022), available at: https://www.sec.gov/rules/final/2022/33-11125.pdf.

SEC Adopts Amendments to Form N-PX Regarding Proxy-Voting Disclosures for Registered Funds and Institutional Investment Managers

On November 2, 2022, the SEC adopted amendments to Form N-PX to expand proxy voting disclosures for registered funds. The SEC also adopted a new rule requiring institutional investment managers to annually report their proxy votes regarding executive compensation matters on Form N-PX ("say-on-pay" votes). Funds will be required to file their first reports on amended Form N-PX by August 31, 2024, with these reports covering the period of July 1, 2023 to June 30, 2024.

Amendments to Form N-PX

Identification of Proxy Voting Matters. Funds currently use different descriptions for a specific proxy proposal and are not required to categorize their votes by type, which, according to the SEC, can make it difficult for investors to compare votes by funds on a proposal. To address this, amended Form N-PX will require a "brief identification of the matter voted on," which must (i) use the same language that is on the form of proxy to identify the matter; (ii) identify all matters in the same order as on the form of proxy; and (iii) identify each director separately, in a director election, in the same order as on the form of proxy, even if presented as a single matter on the form of proxy. In a change from the proposal, the new requirements to mirror the form of proxy

apply only to proxies for which a proxy card is required under Rule 14a-4 of the Exchange Act. For proxies not subject to Rule 14a-4, reports must provide a brief identification of the matter voted on, consistent with the current Form N-PX requirement.

Categorization of Proxy Voting Matters. To assist investors in focusing on important topics, amended Form N-PX requires funds to categorize each matter from a specified list of fourteen categories. As a result of input from the industry, the SEC streamlined and consolidated the proposed list of categories in an attempt to reduce overlap and make the categories easier to use. The fourteen categories in the final rule are: “Director elections,” “Section 14A say-on-pay votes,” “Audit-related,” “Investment company matters,” “Shareholder rights and defenses,” “Extraordinary transactions,” “Capital structure,” “Compensation” (other than Section 14A say-on-pay), “Corporate governance,” “Environment or climate,” “Human rights or human capital/workforce,” “Diversity, equity, and inclusion,” “Other social issues,” and “Other,” a residual category requiring a brief description. The categories are non-exclusive and all categories applicable to the matter must be selected.

Quantitative Disclosure and Securities Lending. Current Form N-PX requires disclosures regarding how the shares were voted (for, against, or abstain) and whether votes cast were for or against management. However, investors currently do not have visibility on when their shares are not voted because their securities are on loan. Amended Form N-PX introduces quantitative disclosures on: (i) the number of shares that were voted; (ii) a breakdown of how those shares were voted, if cast in multiple manners; and (iii) the number of shares that were loaned out and not recalled. Optional Item 1(o) of Form N-PX allows the reporter to provide any additional information regarding the matter or how it voted. These amendments are intended to provide greater transparency on the impact of securities lending on voting practices and split voting.

Structured Data. The amendments also provide that funds must file Form N-PX in a custom XML-based structured data, which is designed to standardize proxy voting disclosures and make the filings easier to analyze. Amended Form N-PX also allows managers who did not vote on any proxy voting matter and have a clearly disclosed policy of not voting on such matters to indicate this on the form and provide no further disclosure about the matter.

Exchange Act Rule 14Ad-1 for Institutional Investment Managers

New Rule 14Ad-1 under the Exchange Act requires institutional investment managers that are subject to the reporting requirements of section 13(f) of the Exchange Act to disclose say-on-pay votes on Form N-PX. This includes proxy matters regarding executive compensation and golden parachute compensation in connection with a merger or acquisition. Consistent with the proposal, a manager is required to report a say-on-pay vote for a security only if the manager: (i) has the power to vote, or direct the voting of, a security; and (ii) “exercises” this power to influence a voting decision. While the SEC acknowledged that it could be somewhat subjective to determine whether a manager exercises the power to vote a security, it declined to make any changes to the proposed standard.

Enhanced Reporting of Proxy Votes by Registered Management Investment Companies; Reporting of Executive Compensation Votes by Institutional Investment Managers, SEC Release No. IC-24745 (Nov. 2, 2022), available at: https://www.sec.gov/rules/final/2022/33-11131.pdf.

SEC Amends Rules Relating to Rule 10b5-1 Trading Plans and Imposes Additional Disclosure Requirements

On December 14, 2022, the SEC adopted amendments to Rule 10b5-1 under the Exchange Act and added related new disclosure requirements in an effort to address concerns about perceived abuse of the rule and to impose additional disclosure requirements on issuers. Among other things, Rule 10b5-1 provides an affirmative defense to insider trading liability, when certain conditions are met, for trades that occur pursuant to a written plan adopted at a time when the trader was not aware of any material nonpublic information. Notably, the vote adopting the new rules was unanimous, reflecting a general consensus on the need for Rule 10b5-1 reform. The amendments introduce new conditions to being able to utilize the affirmative defense against insider trading liability contained in the rule, including prescribed cooling-off periods, additional certifications, limitations on overlapping plans, limitations on single-trade plans and an amended good faith condition. The new conditions other than the amended good faith condition were not applied at this time to issuer share repurchases. In addition, the new disclosure rules will, among other things, require quarterly disclosure by issuers regarding the use of Rule 10b5-1 plans and other trading arrangements by their directors and officers and annual disclosure by issuers regarding their insider trading policies and procedures.

New Conditions Impacting Rule 10b5-1 Plans

The five new conditions that must be met to be able to rely on Rule 10b5-1's affirmative defense are summarized as follows.

Cooling-Off Periods. If the insider is a director or officer of the issuer, then no trades can be made under the plan until the later of (i) 90 days after the adoption or modification of the plan, and (ii) two business days following the disclosure of the issuer's financial results in a periodic report (Forms 10-K or 10-Q) for the fiscal quarter in which the plan was adopted or modified, subject to a maximum cooling-off period of 120 days. For most plans, the required cooling-off period will generally be 90 days; however, for plans adopted in the fourth fiscal quarter, given the later deadline for Form 10-K filings, it is possible that the cooling-off period would need to be extended to the second part of the rule. If the insider is a person other than the issuer, director, or officer, no trades can be made under the plan until 30 days after its adoption or modification.

Additional Certifications. If the insider is a director or officer of the issuer, the plan must include a certification by the insider that, on the date of the plan's adoption, the insider is (i) not aware of any material nonpublic information about the security or the issuer, and (ii) adopting the plan in good faith and not as part of a plan or scheme to evade Rule 10b-5's prohibitions.

Limitations on Overlapping Plans. If the insider is a person other than the issuer, such insider cannot have any other plan outstanding, other than pursuant to one of the following exceptions:

- A series of separate contracts with multiple broker-dealers or other agents can be treated as a single plan if the contracts, when taken as a whole, meet all of the applicable conditions of Rule 10b-5.
- A later-commencing plan that does not authorize trades to begin until after all trades under the earlier-commencing plan are completed or expire is permitted. This exception is not available, however, in certain circumstances where the earlier-commencing plan is terminated rather than expiring under its terms.
- A plan authorizing an agent to sell only such securities as are necessary to satisfy tax-withholding obligations arising exclusively from the vesting of a compensatory award that does not otherwise allow the insider to exercise control over the timing of such sales is permitted.

Limitations on Single Trade Plans. If the insider is a person other than the issuer and is seeking to rely on the affirmative defense for a single-trade plan, such insider cannot have relied on the affirmative defense for another single-trade plan within the last 12 months.

Amended Good Faith Condition. For all types of insiders, the amended good faith condition requires the insider to have acted in good faith with respect to the plan more broadly, not just in connection with entering into the plan.

Additional Disclosure Requirements

As part of its rulemaking, the SEC adopted several new disclosure requirements. Disclosure requirements regarding the adoption, modification, termination, and material terms of officer and director trading arrangements under Item 408(a) of Regulation S-K apply to annual and quarterly reports on Forms 10-K and 10-Q or amendments to them, but will not apply to registered investment companies, which do not file reports on Forms 10-K and 10-Q. These changes are summarized below.

Quarterly Reporting of Director and Officer Trading Arrangements. Companies will be required to disclose whether any director or officer adopted or terminated any Rule 10b5-1 plans or other pre-planned trading arrangements during the company's last fiscal quarter. In relation to such disclosure, companies will be required to provide a description of certain material terms of the plans or trading arrangements at issue.

Disclosure of Insider Trading Policies and Procedures. Under the new rules, companies will be required to disclose on an annual basis whether they have adopted insider trading policies and procedures governing the purchase, sale, and/or disposition of the company's securities by directors, officers, and employees, or the registrant itself, that are reasonably designed to promote compliance with insider trading laws, rules, and regulations, as well as any applicable listing standards. If a company has not adopted such policies and procedures, it must explain why it has not done so. Companies that have adopted such policies and procedures must file them as an exhibit to the related annual report or proxy statement.

Disclosure of Option Grants and Similar Equity Instruments Made Close in Time to the Release of Material Nonpublic Information. Companies will specifically be required to provide narrative disclosure regarding their policies and practices on timing of awards of stock options and other similar option-like instruments in relation to their disclosure of material nonpublic information. Companies will also be required to provide tabular disclosure of awards made in the four business days before a periodic or current report filing that discloses material nonpublic information and ending one business day after such filing.

Identification of Rule 10b5-1 Plan Transactions on Forms 4 and 5 and the Reporting of Gifts on Form 4. Forms 4 and 5 will be updated for filers to identify if a reported transaction is pursuant to a plan that is intended to satisfy the affirmative defense conditions of Rule 10b5-1. Additionally, gifts will now be required to be reported on Form 4.

The final rules will become effective 60 days following publication of the release in the Federal Register.

Insider Trading Arrangements and Related Disclosures, SEC Release Nos. 33-11138 (Nov. 2, 2022), available at: https://www.sec.gov/rules/final/2022/33-11138.pdf.

SEC Enforcement

Investment Adviser Fined Over Principal Account Trades and Cross Trades

On November 21, 2022, the SEC settled charges against Legal & General Investment Management America, Inc. (“LGIMA”), a registered investment adviser, for violating restrictions on principal account transactions and cross trades and related policy and procedure violations. From August 2017 through December 2020, LGIMA arranged 44,125 principal account transactions and 126,249 equity cross trades, the vast majority of which were effected through an automated trade matching program implemented in May 2019. LGIMA internally matched buy and sell orders across its advisory client accounts and advisory client accounts of affiliates and sent them to a third-party broker to execute at a reduced or no commission rate.

Principal Trades

According to the settlement order, LGIMA violated the anti-fraud provision of the Advisers Act by conducting principal trades with client accounts without written disclosure to, and consent from, the affected clients. Throughout the relevant period, LGIMA’s Cross Trading Policy specifically stated that LGIMA did not engage in principal trades. As a result, LGIMA also failed to implement written policies and procedures reasonably designed to prevent these violations, did not offer adequate training on the regulatory requirements of principal transactions, and did not take steps to ensure personnel did not engage in principal transactions.

Cross Trades

The settlement order also found that LGIMA caused certain of its investment company clients to violate Section 17(a) of the 1940 Act, which prohibits any affiliated person of a registered investment company, or any affiliated person of such person, to knowingly purchase a security from the investment company when acting as principal. However, Rule 17a-7 exempts certain cross trades where the affiliation between parties is solely by reason of having a common investment adviser, provided that the transaction meets certain requirements. Among the protective conditions, Rule 17a-7 generally requires that cross trades: (i) involve a security for which market quotations are readily available; and (ii) be effected at the independent current market price of the security. Rule 17a-7 contains a number of other requirements, including that the transaction be consistent with the policy of each fund; that no commission, fee or other remuneration be paid in connection with the transaction; that the board (including a majority of independent directors) take certain actions; and that the fund maintain certain records.

Of the more than 126,000 cross trades that LGIMA arranged, 547 involved an LGIMA registered investment company client account and an affiliated person of those registered investment companies or an affiliated person of such persons. LGIMA did not identify or monitor cross trading involving its registered investment company

client accounts, and it failed to implement its own stated cross trading policy requiring email documentation and compliance approval of cross trades. Moreover, because LGIMA failed to disclose such cross trades to the registered investment company's board, the board could not determine whether the cross trades complied with its procedures and with Rule 17a-7.

Without admitting or denying the SEC's findings, LGIMA agreed to a cease and desist order, censure, and civil monetary penalty of $500,000. In determining to accept LGIMA's settlement offer, the SEC took into consideration LGIMA's remedial acts, self-reporting, and cooperation. Specifically, LGIMA self-reported the potential violations to the SEC staff and provided detailed responses to staff questions. LGIMA stopped all cross trading and implemented new procedures to prevent any cross trades until it could relaunch its cross-trading program with hard-coding to prevent any impermissible principal trades or cross trades. LGIMA also hired outside counsel and an economic consultant to conduct a review of its trading practices. In addition, LGIMA disclosed the violations to its advisory clients and implemented mandatory compliance training on cross trading and principal trades for all trading, legal, compliance, and operational employees.

In the Matter of Legal & General Investment Management America, Inc., SEC Admin. Proc. File No. 3-21244 (Nov. 21, 2022), available at: https://www.sec.gov/litigation/admin/2022/ia-6188.pdf.

SEC Announces FY 2022 Enforcement Results and Trends

On November 15, 2022, the SEC announced its enforcement results for fiscal year 2022. Over the year, the SEC filed 760 total enforcement actions, up significantly from the 697 actions filed in the 2021 fiscal year. Penalties, disgorgement, and pre-judgment interest jumped to a record $6.439 billion, up 67% from the previous year. According to Division of Enforcement Director Gurbir S. Grewal, this robust enforcement signifies the SEC's ongoing determination to protect investors and deter wrongdoing in the U.S. financial markets.

The SEC issued enforcement actions against a wide variety of market participants, including broker-dealers, investment advisers, auditors, and individuals. Notably, the SEC focused on compliance in the evolving cybersecurity and ESG spaces, including charges against Morgan Stanley for failing to protect the personal identifying information of its customers and charges against BNY Mellon for materially misleading statements and omissions about its consideration of ESG principles in making investment decisions for certain mutual funds. Some of the year's largest penalties, totaling $1.235 billion, were issued as a result of the SEC's actions against JP Morgan Securities LLC, 15 other broker-dealers, and one investment adviser for widespread and longstanding failures to maintain and preserve work-related communications on employees' personal devices.

Another significant focus of the SEC has been on private funds and the rapid growth of private fund assets managed by advisers. The SEC took action on undisclosed conflicts of interest, fee arrangements, valuation procedures, and the protection of material nonpublic information. In the 2022 fiscal year, the SEC charged Allianz

Global Investors U.S. LLC and three of its portfolio managers for failing to disclose various trading strategy risks. It imposed a penalty in excess of $1 billion and over $5 billion in restitution to investors.

The SEC also issued several enforcement actions against registered investment advisers for failing to (i) accurately update Forms ADV; (ii) comply with the 1940 Act Custody Rule; (iii) offset management fees; and (iv) fully disclose to investors the different fees and expenses charged. The SEC also charged broker-dealers and registered investment advisers for failing to disclose conflicts of interest under the 1940 Act and for violations of Regulation Best Interest.

While the SEC acknowledged the punitive record it set for fiscal year 2022, Director Grewal stated that he does not expect the Enforcement Division to set new records each year. Rather, he stated that he believes the 2022 enforcement results will have a deterring effect, which will ultimately result in changed behavior and increased compliance.

SEC Announces Enforcement Results for FY22, SEC Press Release (Nov. 15, 2022), available at: https://www.sec.gov/news/press-release/2022-206.

Industry Developments

DOL Issues Final Rule on ESG Investing and Proxy Voting

The U.S. Department of Labor recently issued a final rule that seeks to clarify the circumstances under which a fiduciary subject to ERISA may consider climate change and other ESG factors when making investment decisions (and exercising shareholder rights) on behalf of ERISA plans and "plan asset" vehicles. Many fund sponsors structure their funds to avoid being deemed to hold "plan assets," such as by relying on the "venture capital operating company" and "real estate operating company" exceptions or by satisfying the "25% test." In those instances, ERISA is not applicable to the management of those funds and the general partner (and investment manager) of such fund need not comply with the final rule. Note that, while the final rule does not directly implicate the sponsor of a non-plan assets fund, the final rule may nonetheless affect its marketability to prospective ERISA plan limited partners. Moreover, governmental plans are not subject to ERISA; however, their governing laws may contain ERISA-like language and compliance therewith may be informed by DOL rules, such as the final rule. The final rule largely goes into effect on January 30, 2023.

At a high level, the final rule is not intended to encourage, much less mandate, a fiduciary's consideration of ESG factors when making investment decisions (or exercising shareholder rights) related to investments held by a plan. Instead, the final rule clarifies the ways in which an ERISA fiduciary may consider ESG factors, and exercise shareholder rights related to plan investments, in a manner consistent with ERISA's duties of prudence and loyalty.

Investment Risk/Return Factors. The final rule reaffirms the DOL's longstanding position that a fiduciary should base its investment decisions on factors that the fiduciary reasonably determines are relevant to an investment's risk and return. Moreover, fiduciaries may not sacrifice investment returns or take on additional investment risk to further objectives that are unrelated to the provision of retirement or other financial benefits under the plan.

Tie-Breaker Test. The final rule breathes new life into a fiduciary's ability to use an ESG characteristic of an investment, which does not affect risk/return, as the decisive factor in selecting one investment over another, provided both investment opportunities "equally serve the financial interests of the plan over the appropriate time horizon." This framework (known as the "tie-breaker" test) has long been available under DOL guidance. In 2020, however, the Financial Factors rule recast the tie-breaker test in such a way, and imposed such restrictions on its use, including a heighted documentation requirement, that some felt nullified the test itself. The final rule reinstates the tie-breaker test but disregards the additional documentation requirement, adding an additional tool for fiduciaries to consider ESG factors without violating ERISA's fiduciary duties.

QDIAs. The final rule now provides that a plan fiduciary may select a "qualified default investment alternative" ("QDIA"), the default investment option on a 401(k) plan menu, under the same standard as any other investment option. This is a marked change from the Financial Factors rule, which provided that a fund could not be selected as a QDIA if it, or any of its component funds, had investment objectives, goals or principal investment strategies that included, considered, or indicated the use of non-pecuniary factors.

Participant Preferences. The final rule clarifies that fiduciaries do not automatically violate ERISA's duty of loyalty by taking plan participants' preferences into account when constructing a 401(k) plan lineup. On the one hand, this aspect of the final rule may lead to greater incorporation of ESG funds in plan lineups. On the other hand, however, it remains to be seen how plan fiduciaries will actually ascertain the preferences of plan participants and whether the steps to gather that information may ultimately be an additional source of litigation risk. Lastly, it is imperative to note that fiduciaries remain duty-bound to prudently select investment options, such as by considering an investment option's track record, fees, and expenses, etc., and this is an area that remains subject to relentless class action litigation.

ESG Factors as Investment Risk/Return Factors. The final rule reiterates the DOL's historical position that fiduciaries can and should consider any and all factors that are relevant to the risk/return analysis. In this respect, both the final rule and the DOL's prior authority over the past ten years, including the Financial Factors rule, all expressly acknowledge that ESG factors may, under certain circumstances, in fact affect an investment's risk/return characteristics. This means that a fiduciary may consider the ESG factor alongside other relevant risk/return factors — without needing to satisfy the aforementioned tie-breaker test — if the fiduciary prudently determines that the factor is relevant to investment performance.

Shareholder Rights. The final rule clarifies that the voting of proxies, and the exercise of other shareholder rights, with respect to ERISA plan assets is fiduciary conduct under ERISA. Moreover, proxies should be voted unless a responsible plan fiduciary determines voting proxies are not in the plan's best interest, such as where the costs to do so are exceptionally high. This means that the fiduciary, when exercising shareholder rights on behalf of a plan, must (i) act solely in accordance with the economic interests of the plan; (ii) consider any costs involved; (iii) not subordinate the interests of the participants and beneficiaries in their retirement income or financial benefits to any other objective; and (iv) evaluate relevant facts that form the basis for the proxy vote or other exercise of shareholder rights.

Proxy Advisory Firms. The final rule includes a general requirement that a fiduciary monitor proxy advisory firms, though it did not retain the more specific monitoring duties that were included in the Financial Factors rule. The DOL expects fiduciaries to assess the qualifications of the proxy advisors and the reasonableness of the fees for such services, as well as to be fully informed of potential conflicts of the proxy advisor and the steps such proxy advisor has taken to address them.

Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights, 87 FR 73822 (Dec. 1, 2022), available at: https://www.govinfo.gov/content/pkg/FR-2022-12-01/pdf/2022-25783.pdf.

ICI President Weighs in on SEC Regulatory Agenda

The Wall Street Journal recently published an op-ed authored by Eric Pan, President and CEO of the ICI, in which Pan asserted that the current SEC leadership is ignoring the real-world effects of its regulations on market participants and instead described the current rulemaking approach as "regulation by hypothesis." Pan targeted his criticism on four fund-related rulemakings: money-market fund reform, new beneficial ownership reporting standards, cybersecurity risk-management and the names rule. He cited unpredictable costs, enormous burdens on asset managers and service providers, and elusive benefits for shareholders and markets. He recommended the SEC renew its focus on developing rules that address identified problems and are practical to implement.

The SEC's Rules Are Getting Unreal, The Wall Street Journal (Oct. 31, 2022), available at: https://www.wsj.com/articles/sec-securities-exchange-commission-investment-swing-reporting-requirements-cybersecurity-11667246912.

SEC Staff Guidance

SEC Addresses Regulation S-ID Compliance Issues for Investment Advisers and Broker-Dealers

On December 5, 2022, the SEC's Division of Examinations issued a Risk Alert highlighting the most frequently observed Regulation S-ID compliance issues from recent examinations of SEC-registered investment advisers and broker-dealers (collectively, "firms"). Regulation S-ID requires firms that offer or maintain certain covered accounts to identify these accounts and develop and implement an Identity Theft Prevention Program designed to detect, prevent, and mitigate identity theft in the identified accounts. Generally, Regulation S-ID covers accounts that are used primarily for personal, family, or household purposes that are designed to permit multiple payments or transactions, or any other account for which there is a reasonably foreseeable risk to customers from identity theft. The Staff noted that such personal, family, or household accounts could include registered investment companies that allow wire transfers or check writing privileges or individual accounts at registered investment advisers when the adviser can direct transfers or payments to third parties.

The Staff observed that firms failed to identify covered accounts by not:

- conducting an assessment of whether any of their accounts were "covered accounts;"
- reassessing and identifying new covered accounts over time (such as after a merger with another firm);
- identifying new types of accounts that were covered accounts, such as online accounts or retirement accounts.

Regulation S-ID requires an Identity Theft Program to be appropriate given the size and complexity of the firm and the nature and scope of its activities. The Staff noted several common deficiencies that were observed during recent examinations, including:

- failing to tailor the Identity Theft Program to the business model, such as by using a generic Program or merely restating the requirements of Regulation S-ID;
- failing to cover all the required elements of Regulation S-ID;
- relying on pre-existing policies and procedures, such as anti-money laundering procedures, that were not designed to detect and respond to identity theft concerns;
- failing to reconcile identified procedures for detecting and responding to specific red flags with actual procedures; and
- failing to conduct a risk assessment of the methods of opening, closing, and accessing different types of accounts, such as online accounts.

The Staff also described common deficiencies with respect to firms' identification of "Red Flags." Under Regulation S-ID, Red Flags are patterns, practices, or specific activities that indicate the possible existence of identity theft. Like other aspects of the Identity Theft Program, the identification and detection of Red Flags must be relevant to each firm's business model and its actual experience with identity theft.

The Risk Alert also noted several deficiencies related to inadequate Identity Theft Program implementation and administration. Specifically, the Staff noted firms failing to:

- provide sufficient information to senior management designated to oversee the Identify Theft Program;
- sufficiently train employees on the requirements of Regulation S-ID; and
- evaluate the controls in place for service providers who perform activities in connection with covered accounts.

Observations From Broker-Dealer and Investment Adviser Compliance Examinations Related to Prevention of Identity Theft Under Regulation S-ID, SEC Division of Examinations Risk Alert (Dec. 5, 2022), available at: https://www.sec.gov/files/risk-alert-reg-s-id-120522.pdf.

SEC Extends Temporary Relief for Private Issuers of Fixed Income Securities

In 2020, the Securities and Exchange Commission amended Rule 15c2-11 under the Exchange Act to prohibit broker-dealers from providing price quotations in over-the-counter securities unless specified information about the issuer of the securities is current and publicly available. Notably, in 2021, the SEC clarified that amended Rule 15c2-11 applies to debt securities issued in private offerings pursuant to Rule 144A and Regulation S under the Securities Act, in addition to equity securities. Pursuant to this clarification, issuers of these privately-placed debt securities, many of which are not public reporting companies under the Exchange Act, will face a choice between significantly expanding the scope of information they make public to enable broker-dealers to continue to provide price quotations, or, alternatively, risking reduced liquidity (and a corresponding negative impact on price) in the markets for such securities.

Exchange Act Rule 15c2-11 was adopted to address fraudulent behavior generally associated with stock trading in the over-the-counter (OTC) market. Under the amendments, broker-dealers may not publish a quotation for an issuer's security when key information is not current and publicly available. Since the adoption of the amendments to Rule 15c2-11, concerns have been raised regarding the negative impact the amendments have on trading in the fixed-income markets and the inability of market participants to complete the operational and system changes required to comply with the amendments. The original compliance date for amended Rule 15c2-11 was September 28, 2021, which was extended to January 4, 2023 for issuers of fixed income securities. Following

requests from market participants for additional relief, on November 30, 2022, the SEC issued a no-action letter temporarily extending the compliance date for issuers of fixed income securities to January 4, 2025.

SEC Division of Trading and Markets, No-Action Letter, *Amended Rule 15c2-11 in Relation to Fixed Income Securities* (Nov. 30, 2022), available at: https://www.sec.gov/files/fixed-income-rule-15c2-11-nal-finra-113022.pdf.

Litigation

Jury Orders Hedge Fund Founder to Pay $8.2 Million for Overvaluation Missteps

On December 20, 2022, a federal jury ordered David Bodner, co-founder of hedge fund, Platinum Partners, to pay $8.2 million into the fund's bankruptcy liquidation for breach of fiduciary duty. Bodner's trial opened on November 30, 2022, with the liquidators alleging that Bodner was aware Platinum co-founder Mark Nordlicht inflated the value of assets in the fund and did nothing to counter the scheme because his fees rose in parallel to the increased valuations. However, Bodner testified that he had a limited role at the fund with no control over its valuation.

Jurors reported that they were deadlocked on December 19, but were able to reach agreement after the judge encouraged them to seek consensus. The verdict was a small fraction of the $50 million sought by the fund's liquidators.

Verdict Form: Martin Trott and Christopher Smith v. David Bodner (Dec. 20, 2022),
No. 18-cv-10936 (JSR) (S.D.N.Y.).

RIA Prevails Against SEC in Court Over 12b-1 Fees

In December 2020, the SEC filed a complaint in federal district court against CapWealth, a registered investment advisor, alleging that CapWealth did not properly disclose conflicts of interest to clients when it placed its clients in mutual funds share classes that charged Rule 12b-1 fees. This action is part of the SEC's ongoing scrutiny and enforcement of investment advisers' share class selection practices. On November 1, 2022, the federal jury found in favor of CapWealth.

The SEC sought financial penalties against CapWealth, its founder and chief investment officer, and its Managing Director for Wealth Management, claiming that the defendants advised clients to purchase share classes that bore 12b-1 fees when clients were eligible for share classes that did not bear such fees. The SEC estimated that affected advisory clients paid over $450,000 in "avoidable" fees over a three-year period. Further, the SEC alleged that CapWealth's affiliated broker-dealer received 12b-1 fees from these investments and shared portions of the fees with CapWealth employees who were registered representatives of the broker-dealer.

In response, CapWealth argued that its conflicts disclosure was adequate and that it decreased its advisory fees for clients who paid 12b-1 fees to compensate for the additional cost. CapWealth further noted that 12b-1 fees are

tax-deductible for clients, while advisory fees are not. As such, clients that were placed in a share class that paid 12b-1 fees did not necessarily pay more fees on balance.

A jury rejected the charges against CapWealth on all counts after a four-day trial. The verdict served as a victory for a small group of RIAs that have emphatically resisted the SEC's efforts to attack adviser share class selection practices.

Verdict Form: SEC v. CapWealth Advisors, LLC (Nov. 1, 2022),
No. 3:20-cv-1064 (M.D. Tenn.).

Collapse of Infinity Q Funds: CCO, Investors, and Fund Reach Separate Settlements

Background

In September 2022, separate settlements were reached with the SEC and investors in a class action lawsuit in connection with a fraudulent valuation scheme involving Infinity Q Diversified Alpha Mutual Fund, a series fund of Trust for Advised Portfolios, a registered investment company, and its parallel hedge fund (collectively, the "Funds") both of which were managed by Infinity Q Capital Management LLC ("Infinity Q"). According to the settlements, from February 2017 through February 2021, James Velissaris, founder and former chief investment officer of Infinity Q, manipulated valuation models from third-party pricing services and altered inputs to hide the Funds' poor performance. Velissaris manipulated the valuations by: (i) altering the computer code in the pricing service valuation models; (ii) knowingly entering incorrect inputs into the pricing service; (iii) selecting valuation models that he knew could not accurately value the relevant Fund positions; and (iv) knowingly cherry-picking valuation inputs. Velissaris' actions resulted in the overvaluation of the Funds by over $1 billion by September 2020.

On February 19, 2021, redemptions in the Funds were halted and the Funds were subsequently liquidated with investors suffering massive losses. Thereafter, several Fund investors brought a class action lawsuit against the Funds, directors, officers and several service providers. On February 17, 2022, the United States Attorney's Office for the Southern District of New York charged Velissaris with securities fraud, making false statements to auditors, and obstruction of justice. On the same day, the SEC and CFTC commenced civil actions against Velissaris for violating the anti-fraud provisions of the federal securities laws. On November 21, 2022, Velissaris pled guilty to the securities fraud charges brought by the Southern District of New York. According to the plea agreement, Velissaris faces 19 ½ to 20 years in prison and a fine ranging from $50,000 to $5 million under the advisory sentencing guidelines. He has agreed to forfeit $22 million and will be sentenced in March 2023. On September 30, 2022, the SEC settled charges against Scott Lindell, Infinity Q's former Chief Risk Officer, Head of Operations, and Chief Compliance Officer. Velissaris continues to face charges brought by the SEC and CFTC.

CCO Settlement

The SEC's Complaint against the Funds' CCO, Lindell, alleged that he was aware of Velissaris' fraudulent valuation scheme and failed to investigate the independence of the pricing services. It was also noted that the CCO participated in the scheme by misrepresenting to investors and directors that the pricing services were "independent" of Infinity Q. The SEC found the CCO willfully made misstatements on Infinity Q's Form ADV filings, assisted Velissaris in submitting misleading documents to the Staff, and misled Infinity Q's auditor.

The CCO agreed to settle the charges. The settlement, which is subject to court approval, permanently enjoins the CCO from violating the federal securities laws and includes disgorgement, prejudgment interest, and civil money penalties in amounts to be decided by the Court.

Class Action Settlement

In connection with this valuation scheme, the Funds and their directors, officers, and service providers entered into a Stipulation of Settlement with Fund investors. The Defendants include the Funds, Infinity Q, the Funds' directors and officers, the Funds' distributor, the Funds' independent accounting firm, and the Funds' transfer agent.

The lawsuit alleged that the Defendants made materially false and misleading statements and failed to disclose material information on the valuation process for the Funds. The lawsuit also alleged that the Defendants did not adhere to the Funds' valuation procedures and tampered with third-party pricing models, which led to the overstated valuation of fund assets.

On September 7, 2022, the Defendants submitted a proposed stipulation of settlement to the U.S. District Court in the Eastern District of New York. Pursuant to the Class Action Settlement, the Defendants have agreed to a cash settlement of $39,750,000 which can increase up to $48,000,000 based on the occurrence of certain contingencies (the "Settlement Fund"). Each Defendant has agreed to pay the following amounts: (i) $4,600,000 by the Funds and Fund officers and directors; (ii) $2,500,000 by the distributor; (iii) $16,750,000 by the auditor; (iv) $250,000 by the transfer agent; and (v) $15,650,000 by Infinity Q. Infinity Q also assigned its rights to up to $3,000,000 of insurance proceeds to the Settlement Fund.

Appointment of a Special Master

On November 10, 2022, the SEC filed a settled action against the Infinity Q Diversified Alpha Mutual Fund. As part of its complaint, the SEC is seeking the appointment of a special master over the Fund to oversee the distribution of remaining assets to harmed investors. The settlement, pursuant to which the Fund is permanently enjoined from violating Rule 22c-1 under the 1940 Act, and the appointment of a special master are subject to court approval.

Securities and Exchange Commission v. Scott Lindell, 1:22-cv-08368 (S.D.N.Y. Filed September 30, 2022), available at: https://www.sec.gov/litigation/complaints/2022/comp25542.pdf; *In re Infinity Q Diversified Alpha*

Fund and Infinity Q Volatility Alpha Fund, L.P. Securities Litigation, No. 1:21-cv-1047-FB-MMH (E.D.N.Y.); *Securities and Exchange Commission v. Infinity Q Diversified Alpha Fund*, 1:22-cv-09608 (S.D.N.Y. Filed November 10, 2022), available at: https://www.sec.gov/litigation/complaints/2022/comp25575.pdf; *United States of America v. James Velissaris*, 1:22-cr-00105 (S.D.N.Y. Nov. 21, 2022).

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