Simpson Thacher

Registered Funds Regulatory Update

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SEC Rulemaking

SEC Proposes New Cybersecurity Risk Management Rules for Advisers and Funds

On February 9, 2022, the SEC proposed new Rule 38a-2 under the Investment Company Act and Rule 206(4)-9 under the Advisers Act, which, if adopted, will require registered investment companies, business development companies and registered investment advisers to adopt and implement written cybersecurity policies and procedures. The proposed rules are designed to address concerns about the growing sophistication of cyber threat actors in the industry by enhancing investor protection against cybersecurity risks and providing the SEC with more comprehensive oversight of such risks and incidents. The proposed rules and related amendments would require:

1. advisers and funds to adopt and implement written cybersecurity policies and procedures, including specific enumerated elements, reasonably designed to address cybersecurity risks that could harm fund investors and advisory clients;
2. reporting of significant adviser and fund cybersecurity incidents within 48 hours to the SEC on proposed Form ADV-C, a new confidential reporting form;
3. enhanced disclosures relating to cybersecurity risks and incidents to existing and potential investors; and
4. advisers and funds to maintain, make, and retain certain cybersecurity-related books and records.

Highlights of the proposed rules and related amendments include the following:

Adoption of Cybersecurity Policies and Procedures. The first element of the proposed rules addresses the SEC's concerns that advisers and funds have not implemented reasonably designed policies and procedures to sufficiently defend against increasingly complex cybersecurity threats. If adopted, the proposed rules would require advisers and funds to adopt and implement written policies and procedures that would include, among other things, five enumerated elements but would allow them the flexibility to tailor their cybersecurity policies and procedures to the specific nature and scope of their businesses and specific cybersecurity risks. These required elements include:

- performance of periodic written **risk assessments** to categorize and prioritize cybersecurity risks;
- **user security and access controls** designed to minimize user-related risks and prevent unauthorized access to information;
- **information system monitoring** to protect information from unauthorized access;

- **threat and vulnerability management** to detect, mitigate, and remediate cybersecurity threats and vulnerabilities; and
- **cybersecurity incident response and recovery measures** to detect, respond to, and recover from cybersecurity incidents.

Annual Review of Cybersecurity Policies and Procedures. Under the proposed rules, advisers and funds would be required to review and assess the design and effectiveness of the written policies and procedures at least annually, including whether the policies and procedures reflect changes in cybersecurity risks over the review period, and prepare a written report of cybersecurity risks and incidents. The written report should, at a minimum, describe and explain the results of the annual review, assessment, and any control tests performed, document cybersecurity incidents that occurred since the date of the last report, and discuss any material changes to the policies and procedures since the date of the last report.

Board Oversight. A fund's board of directors, including a majority of its independent directors, would be required to initially approve the cybersecurity policies and procedures and no less than annually review the written report. This requirement is designed to provide directors with the information necessary to make informed decisions about the effectiveness and implementation of the cybersecurity policies and procedures and whether the fund has adequate resources with respect to cybersecurity matters.

Reporting Requirements for Cybersecurity and Incidents. The proposed rules provide that advisers must report significant cybersecurity incidents to the SEC on new Form ADV-C, including on behalf of a client that is a registered investment company, a business development company or a private fund. Form ADV-C must be submitted to the SEC within 48 hours after there is a reasonable basis to conclude that a significant cybersecurity incident has occurred. The proposed rules define a "significant cybersecurity incident" as:

> a cybersecurity incident, or a group of related incidents, that significantly disrupts or degrades the adviser's ability, or the ability of a private fund client of the adviser, to maintain critical operations, or leads to the unauthorized access or use of adviser information, where the unauthorized access or use of such information results in: (1) substantial harm to the adviser, or (2) substantial harm to a client, or an investor in a private fund, whose information was accessed.

The SEC believes that collecting information about significant cybersecurity incidents in a structured format on Form ADV-C will enhance its ability to carry out its risk-based examination program, assess trends in cybersecurity incidents across the industry, and better protect investors from any patterned cybersecurity threats.

Disclosure of Cybersecurity Risks and Incidents. The proposed rules would also require enhanced, plain-English disclosure of cybersecurity risks and incidents to investors by modifying Form ADV Part 2A for advisers and Forms N-1A, N-2, N-3, N-4, N-6, N-8B-2 and S-6 for funds. The proposed rules would require advisers to describe cybersecurity risks that could materially affect their advisory services offered. Additionally, advisers

would be required to provide a description of any cybersecurity incident that has occurred within the last two years that has significantly disrupted their ability to maintain critical operations, or has led to the unauthorized access or use of adviser information, resulting in substantial harm to advisers or their clients.

For purposes of disclosure, funds should also consider whether cybersecurity risks are "principal risks" to the fund. For example, a fund that has had multiple cybersecurity incidents in a short period of time may need to reflect this information in its prospectus disclosure.

Recordkeeping. The proposed rules and amendments would require advisers and funds to maintain current and previous records (dating back five years) related to cybersecurity risk management, including any cybersecurity incidents.

In a formal statement released following the publication of the proposed rules, SEC Chair Gary Gensler noted that the proposed rules are "designed to enhance cybersecurity preparedness and could improve investor confidence in the resiliency of advisers and funds against cybersecurity threats and attacks." In her dissenting statement, Commissioner Hester Peirce expressed concerns that the proposed rules would require micromanagement of companies and that they would cast the SEC "as the nation's cybersecurity command center, a role that Congress did not give [the SEC]." She went on to state that "[w]hile the integration of cybersecurity expertise into corporate decision-making likely is a prudent business decision for nearly all companies, whether, how, and when to do so should be left to business—not SEC—judgment."

The proposed rules and related amendments are subject to comment for 30 days after publication in the Federal Register or April 11, 2022, whichever is later.

Cybersecurity Risk Management for Investment Advisers, Registered Investment Companies, and Business Development Companies, SEC Rel. No. 34-94197 (Feb. 9, 2022), available at: https://www.sec.gov/rules/proposed/2022/33-11028.pdf.

SEC Proposes Long-Awaited Climate-Related Disclosure Rules for Public Issuers

The SEC recently approved long-awaited proposed rules aimed at enhancing and standardizing climate-related disclosures in an effort to foster greater consistency, comparability, and reliability of climate-related information among public issuers. The proposal, if adopted, would require domestic registrants and foreign private issuers to include prescribed climate-related information in their registration statements and annual reports substantially beyond what is currently required by existing disclosure rules. Importantly, among other elements, the proposed rules contemplate new attestation requirements for certain issuers and require climate-related financial statement metrics to fall within the scope of an issuer's internal control over financial reporting and be subject to any

required audit. Although the rules would be subject to phase-in periods, issuers are expected to face tremendous challenges in implementing the proposal, if adopted as proposed.

The Enhancement and Standardization of Climate-Related Disclosures for Investors, SEC Rel. No. 33-11042 (Mar. 21, 2022), available at: https://www.sec.gov/rules/proposed/2022/33-11042.pdf.

SEC Proposes Short Sale Disclosure Rules

On February 25, 2022, the SEC announced that it unanimously voted to approve proposed changes requiring certain institutional investment managers to report short sale-related data on certain equity securities to the SEC. A short sale is the sale of a security that the seller does not actually own that is then consummated by the seller delivering a borrowed security. While short selling can be a useful market tool, it can also be used to drive down stock prices, accelerate a declining market in a particular stock or manipulate stock prices

If proposed new Rule 13f-2 under the Exchange Act is adopted, the new rule will make significant changes to short selling disclosure obligations for certain institutional investment managers in connection with the SEC's effort to provide more transparency to market participants and regulators on large short selling activity and mitigate stock price manipulation during times of irregular market volatility. Rule 13f-2 would require institutional investment managers exercising investment discretion over short positions exceeding certain thresholds to file with the SEC, on a nonpublic basis, new Form SHO to report certain data relating to month-end short positions and certain related daily transaction activity. The thresholds specifically depend on whether the short position relates to an equity security of a SEC reporting or non-reporting issuer.

- For SEC reporting issuers, Form SHO is required for each "gross short position" over which the institutional investment manager and any person under its control has investment discretion that (i) has a value of at least $10 million at the close on any settlement date during the calendar month; or (ii) represents a monthly average gross short position as a percentage of shares outstanding in the equity security of at least 2.5%.
- For SEC non-reporting issuers, Form SHO is required for each short position with a value that meets or exceeds $500,000 at the close of any settlement date during the month.

Institutional investment managers that meet the disclosure thresholds in a calendar month would be required to file proposed Form SHO with the SEC via EDGAR within 14 calendar days following the end of such month. The identity of the institutional investment manager filing Form SHO will be kept confidential to avoid retaliation against short sellers. The SEC will then take the reported data on Form SHO and publish aggregate information related to individual equity securities and net activity during the applicable month. The information is intended to fill an information gap into the lifecycle of a short sale not currently publicly available. Current short sale transaction information provided by major U.S. stock exchanges and FINRA does not reflect increases and

decreases in reported short positions. SEC Chair Gary Gensler stated that proposed Rule 13f-2 "would strengthen transparency of an important area of our markets that would benefit from greater visibility and oversight."

The public comment period will remain open until April 15, 2022.

Short Position and Short Activity Reporting by Institutional Investment Managers, SEC Release No. 34-9413 (Feb. 25. 2022), available at: https://www.sec.gov/rules/proposed/2022/34-94313.pdf.

Industry Developments

SEC Division of Examinations Announces 2022 Examination Priorities

The SEC's Division of Examinations announced the following five enumerated priorities for 2022: (i) private funds; (ii) ESG investing; (iii) Regulation Best Interest, fiduciary duties and Form CRS; (iv) information security and operational resiliency; and (v) emerging technologies and crypto-assets. "The Division's 2022 examination priorities identify key risk areas that we expect registrants to address, manage, and mitigate with vigilance," said SEC Chair Gary Gensler.

"In this time of heightened market volatility, our priorities are tailored to focus on emerging issues, such as crypto-assets and expanding information security threats, as well as core issues that have been part of the SEC's mission for decades—such as protecting retail investors," said Division of Examinations' Acting Director Richard R. Best. "Our priorities cover a broad landscape of potential risks to investors that firms should consider as they review and strengthen their compliance programs."

The following is an overview of the Division's 2022 examination priorities:

Private Funds. The Division will prioritize its focus on advisers to private funds, including hedge funds, private equity funds, and real estate funds. The Division will focus its examinations on fiduciary duties, compliance programs, fees and expenses, custody, fund audits, valuation, conflicts of interest, disclosure of investment risks and controls around material non-public information. The Division will also review private fund advisers' portfolio strategies, risk management, and investment recommendations and allocations as well as the disclosures relating to each of those areas.

ESG Investing. The Division recognizes that ESG offerings by funds and advisers have continued to increase to meet investor demands for such products and highlighted that risk disclosures relating to ESG may include "materially false and misleading statements or omissions" given the lack of standardization. This risk may be compounded by the: (i) lack of standardization in ESG investing terminology (*e.g.*, strategies that are referred to as sustainable, socially responsible, impact investing, and ESG conscious); (ii) variety of approaches to ESG investing (*e.g.*, a portfolio may be labeled as ESG because of consideration of ESG factors alongside traditional financial, industry-related, and macroeconomic indicators, among others; other portfolios may use ESG factors as the driving or main consideration in selecting investments; or some portfolios engage in impact investing seeking to achieve measurable ESG impact goals); and (iii) failure to effectively address legal and compliance issues with new lines of business and products.

The Division's focus during examinations will be on: (i) the accuracy of ESG investing disclosure and adoption and implementation of policies, procedures, and practices related thereto; (ii) whether proxy voting aligns with

reported proxy voting policies and ESG-related disclosure; and (iii) "greenwashing" of strategy disclosure, performance advertising and marketing.

Standards of Conduct: Regulation Best Interest, Fiduciary Duty, and Form CRS. The Division will continue to focus on standards of conduct for broker-dealers and advisers, specifically related to compliance with Regulation Best Interest and the fiduciary standards of the Advisers Act. The Division will focus on the duties of care and loyalty, including best execution obligations, financial conflicts and the impartiality of advice.

The Division notes the following areas of assessment for its examinations:

- practices regarding consideration of alternatives (*e.g.*, with regard to potential risks, rewards, and costs);
- management of conflicts of interest (*e.g.*, incentive practices that favor certain products or strategies over others);
- trading (*e.g.*, best execution obligations);
- disclosures (*e.g.*, disclosures set forth in Form ADV and Form CRS and made pursuant to Regulation Best Interest);
- account selection (*e.g.*, brokerage, advisory, or wrap fee accounts); and
- account conversions and rollovers.

The Division will focus on the effectiveness of the compliance programs, testing, training and disclosures that relate to these focus areas.

Information Security and Operational Resiliency. The Division will continue to review whether firms have taken appropriate measures to ensure information security and business continuity. Similar to prior years, the Division will continue to focus on whether firms have taken appropriate action to:

- safeguard customer accounts and prevent account intrusions, including verifying an investor's identity to prevent unauthorized account access;
- oversee vendors and service providers;
- address malicious email activities, such as phishing or account intrusions;
- respond to incidents, including those related to ransomware attacks;
- identify and detect red flags related to identity theft; and
- manage operational risk as a result of a dispersed workforce in a work-from-home environment.

In addition, the Division will continue its focus on business continuity and disaster recovery with particular focus on the impact of climate risk and substantial disruptions to normal business operations.

Emerging Technologies and Crypto-Assets. The Division's final area of focus will be on robo advisers and the technologies and practices they utilize. The Division will specifically focus on robo advisers claiming to offer new products and services to assess whether:

- operations and controls in place are consistent with disclosures and the standard of conduct owed to investors and other regulatory obligations;
- advice and recommendations, including by algorithms, are consistent with investors' investment strategies and the standard of conduct owed to such investors; and
- controls take into account the unique risks associated with such practices.

In addition, the Division will focus on advisers that engage in the offering, sale, and trading of crypto-assets with a specific focus on custody arrangements and the recommendation and advice related to crypto-assets. In particular, the Division will review whether advisers:

- have met their respective standards of conduct when recommending crypto-assets with a focus on duty of care and the initial and ongoing understanding of the products (*e.g.*, blockchain and crypto-asset feature analysis); and
- routinely review, update, and enhance their compliance practices (*e.g.*, crypto-asset wallet reviews, custody practices, anti-money laundering reviews, and valuation procedures), risk disclosures, and operational resiliency practices (*i.e.*, data integrity and business continuity plans).

The Division will also focus their examinations of mutual funds and ETFs that offer exposure to crypto-assets on the compliance, liquidity, and operational controls around portfolio management and market risk.

Investment Advisers and Investment Company Examination Program

Registered Investment Advisers. The Division will continue to review the compliance programs of advisers, including whether those programs and their policies and procedures are reasonably designed, implemented, and maintained. Specifically, the Division will examine the following core areas: marketing practices, custody and safety of client assets, valuation, portfolio management, brokerage and execution, conflicts of interest, and related disclosures. The Division will also focus on areas of heightened risk and the mitigation of such risks. In addition, the Division will continue its focus on fees and expenses, including fee calculations, errors, inaccurate calculations and failures to refund prepaid fees. As in previous years, the Division prioritizes advisers and registered funds that have never been examined, including recently registered firms, and those that have not been examined for a number of years.

Registered Investment Companies. The Division typically reviews certain perennial focus areas during its assessments of funds' compliance programs and governance practices. Perennial areas include, including disclosure to investors, accuracy of SEC reporting, and compliance with new rules and exemptive orders. The Division will also focus on liquidity risk management programs to consider whether the programs are reasonably

designed to assess and manage the fund's liquidity risk and review the implementation of required liquidity classifications, including oversight of third party service providers. The Division will prioritize the examination of money market funds and business development companies. In addition, the Division will focus on certain portfolio investments, including mutual funds investing in private funds, and on funds that engage in certain practices, such as fee waivers and trading activities that may be designed to inflate fund performance.

2022 Examination Priorities, Division of Examinations, SEC (Mar. 20, 2022), available at: https://www.sec.gov/news/press-release/2022-57.

No(tice and) Comment: Lawmakers and SIFMA Urge SEC to Provide Adequate Comment Periods for Rulemaking

In a letter to SEC Chair Gary Gensler, Rep. Patrick McHenry (R-N.C.), ranking member of the House Financial Services Committee, and Sen. Patrick Toomey (R-Pa), ranking member of the Senate Banking Committee, criticized the SEC for "consistently provid[ing] unreasonably short comment periods" since Chair Gensler began his term in April 2021. While comment periods generally last for 60 days, with extended comment periods of 90 or 120 days provided for more complex rules, the Gensler administration has only provided comment periods of 30 or 45 days for rule proposals, with several of those brief timelines coinciding over holiday periods. In their letter, McHenry and Toomey noted that a wider window is necessary to ensure that there is substantive public input in the rulemaking process and is particularly necessary given the Gensler administration's expansive rulemaking mandate. The lawmakers also underscored the critical impact that public comment has on refining and improving adopted rulemakings, in some cases even providing the SEC with grounds to rethink or scrap imprudent rulemakings entirely.

The Securities Industry and Financial Markets Association ("SIFMA") also complained about the tight comment deadline in a January comment letter that raised concerns about the SEC's proposal on securities lending reporting. SIFMA asserted that "the proposed rule would impose significant costs on SIFMA member firms which are not commensurate with the benefits sought to be achieved . . . [h]owever, given the very short comment period, SIFMA and its members [did] not have sufficient time to fully analyze and calculate the true anticipated cost of implementing the proposed reporting regime." More recently, SIFMA submitted a comment letter to the SEC this March challenging the SEC's provision of only 30 days to comment on its notice of proposed rulemaking on procedures governing the filing and processing of prohibited transaction exemptive applications. SIFMA requested an extension of time from 30 days to "at least 60 days" given the "myriad [of] substantive changes . . . and the novel legal and policy theories also involved."

The pushback over the short comment deadlines is just one example of the simmering tensions between Gensler—and his Democratic SEC majority—and Republicans. A potential reason for the tight public comment periods may be due to Gensler's pursuit of an expansive agenda; at just one recent open meeting alone the SEC advanced five

rule proposals. But the tight comment timelines greatly exacerbate the strain already placed on an industry that must triage its limited available resources to determine if and when to respond, especially when multiple proposals are put forth at once. According to a former counsel to SEC Commissioner Elad Roisman, the current comment periods make responding to agency proposals “difficult, if not impossible” and often leaves the smaller firms and softer voices unheard.

Letter from Rep. Patrick McHenry, R-N.C., ranking member of the House Financial Services Committee and Sen. Patrick Toomey, R-Pa ranking member of the Senate Banking Committee to Hon. Gary Gensler, Chair, SEC (January 10, 2022), available at: https://republicans-financialservices.house.gov/uploadedfiles/2022-01-10_pmc_toomey_letter-gensler_sec_comment_period.pdf.

SEC Enforcement

Cryptocurrency Lending Firm BlockFi Announces $100 Million Settlement With SEC and State Regulators Over Unregistered Sale of BlockFi Interest Accounts

In a first-of-its-kind enforcement action, the SEC announced settled charges against BlockFi Lending LLC for failing to register the offers and sales of its retail crypto lending product and violating the registration provisions of the Investment Company Act. The SEC further found that BlockFi made materially false and misleading statements concerning the level of risk in its loan portfolio. As part of the settlement and parallel actions by state securities regulators, BlockFi agreed to pay $100 million in penalties and fines, as well as to cease offering its interest-bearing BlockFi Interest Accounts ("BIAs") to new U.S. customers and accepting new investments from current U.S. investors, and bring its business within the provisions of the Investment Company Act within 60 days. BlockFi also will be required to register its new product, BlockFi Yield, in accordance with SEC rules for the offering of securities. The settlement is the first major enforcement action in the crypto lending sector for SEC Chair Gary Gensler and the case—particularly the allegations that investors were deceived as to the safety of their investments—will likely become an important talking point in the SEC's intensifying crackdown on the crypto sector.

BlockFi, a cryptocurrency lending and trading platform, offered and sold BIAs to investors who deposited cryptocurrency in exchange for variable monthly interest payments. BlockFi generated the interest paid to these investors by deploying assets in various ways, including loaning crypto assets to institutional and corporate borrowers, and investing in equities and futures. Account holders received a variable rate of interest tied to the yield on BlockFi's investment—which recently was advertised as "up to 9.25% APY." The company warned that neither rates nor deposits are guaranteed, and that BIA losses are not insured by the Federal Deposit Insurance Corp. or the Securities Investor Protection Corp.

The Order concludes that BlockFi violated the securities laws in three respects:

First, while BlockFi previously took the position that a BIA is not a security and, therefore, should not be regulated as a security, the SEC concluded the opposite—that the BIAs are securities and should be registered under the Securities Act when publicly offered because they fit the definition of an "investment contract" under the test established by *SEC v. W.J. Howey Co*. Under the so-called "Howey test," an investment contract is "an investment of money in a common enterprise with profits to come" primarily from the efforts of others. Further, the SEC concluded that the BIAs are securities because they fit the definition of "notes" under the four-part "family resemblance" analysis established by *Reves v. Ernst & Young*. Under *Reves*, a note is presumed to be a security

unless it falls into certain judicially created categories of financial instruments that are not securities, or if the note in question bears a "family resemblance" to notes in those categories.

Second, the SEC concluded that BlockFi operated for more than 18 months as an unregistered investment company in violation of the Investment Company Act because it issued securities, and held more than 40% of its total assets (excluding cash) in investment securities, including loans of crypto assets to institutional borrowers.

Third, according to the Order, BlockFi misrepresented on its website that its institutional loans were "typically" over-collateralized, when in fact, most institutional loans were not. Accordingly, the company is alleged to have materially overstated the degree to which it secured protection from defaults by institutional borrowers from collateral.

While the SEC continues to file enforcement actions targeted at specific digital asset securities, it now appears to have turned a sharp focus towards crypto exchanges and lending products. The $100 million in penalties and fines is among the largest regulators have imposed on a cryptocurrency firm.

In the Matter of BlockFi Lending LLC, SEC Admin. Proc. File No. 3-20700 (Feb. 14, 2022), available at: https://www.sec.gov/litigation/admin/2022/33-11029.pdf.

Adviser Charged With Failing to Disclose Conflicts of Interest Regarding 12b-1 Fees and Revenue Sharing Arrangements

The SEC settled charges against O.N. Investment Management Company ("ONIMCO"), a registered investment adviser, for breaching its fiduciary duty for failing to disclose conflicts of interests with its parent company, a registered broker-dealer. Specifically, the Order found that ONIMCO had been generating revenue for O.N. Equity Sales Company ("ONESCO") through its advisory clients without fully and fairly disclosing all material facts.

The Order found that since 2014, ONIMCO advised its clients to purchase or hold mutual fund share classes that charged Rule 12b-1 fees that were paid to ONESCO when lower cost shares of the same funds were available to them. As a result, ONESCO collected 12b-1 fees that it would not have otherwise collected if the clients had been placed in lower-fee share classes. During the same time period, ONIMCO predominantly recommended that its clients use certain money market funds for cash sweep whereby the clearing broker paid ONESCO revenue sharing payments. However, there were other money market funds available that would have paid ONIMCO's clients higher yields for lower fees but without the revenue sharing component. The Order found there were similar issues with a no-transaction fee program offered by an unaffiliated clearing broker that provided ONIMCO access to certain mutual funds where the clearing broker shared no-transaction fee revenue with ONESCO for ONIMCO advisory client assets.

The Order further noted that ONIMCO failed to adopt and implement policies reasonably designed to prevent violations of the federal securities laws with regard to its mutual fund share class and fund selection practices. The Order found that ONIMCO willfully violated Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-7 thereunder. Without admitting or denying the findings, ONIMCO agreed to, among other things, pay disgorgement of $866,257 plus interest and a civil monetary penalty of $210,000.

O.N. Inv. Mgmt. Co., SEC Admin. Proc. File No. 3- 20701 (Jan. 11, 2022).

SEC Settles With Adviser for Alleged "Hedge Clause" Violations

The SEC recently settled charges against Comprehensive Capital Management ("CCM"), a registered investment adviser, for, among other violations, improperly including a liability waiver, or "hedge clause," in its advisory agreements. The SEC generally disfavors the use of hedge clauses in advisory agreements because they can mislead clients into incorrectly believing that they waived a cause of action against an adviser when such claims are non-waivable under federal or state laws.

In 2018, CCM was informed in connection with an SEC Staff examination that a hedge clause in its advisory agreement was overly broad due to the client's waiver of "all claims" and "any act" against the adviser, which the SEC noted would include the adviser's gross negligence, willful misconduct and fraud. Moreover, CCM did not have policies or procedures to assess a client's sophistication on such matters or that required the adviser to explain the hedge clause at in-person meetings or provide enhanced disclosure as to when a client could bring a cause of action despite the hedge clause. As a result, the SEC found that the hedge clause violated the anti-fraud provisions of the Advisers Act. Thereafter, CCM agreed not to enforce the hedge clause but it never provided notice to that effect to its clients.

Then, in 2019, the SEC published the *Commission Interpretation Regarding Standard of Conduct for Investment Advisers* stating that there "are few (if any) circumstances in which a hedge clause in an agreement with a retail client would be consistent with antifraud provisions . . . ." The guidance went on to note that questions of whether hedge clauses in agreements with institutional clients violate the anti-fraud provisions of the Advisers Act would be "determined based on the particular facts and circumstances" of each matter.

Following the SEC's guidance, CCM revised its hedge clause in its advisory agreement to state that CCM would: (i) only be liable for its own acts of gross negligence or willful misconduct; and (ii) not be liable for any act or omission, or the failure or inability to perform any obligation, of any broker-dealer, investment adviser, sub-custodian or other agents or affiliates selected by CCM with reasonable care or for any incidental, indirect, special, punitive or consequential damages. The hedge clause was followed by a statement that nothing in the advisory agreement would waive or limit any rights a client would have under federal or state securities laws.

Upon review, the SEC determined that the new hedge clause violated the anti-fraud provisions of the Advisers Act because the hedge clause: (i) appears to relieve CCM from liability for acts the client has a non-waivable cause of action provided by federal or state law; (ii) could mislead retail clients into not enforcing their legal rights; and (iii) included a false statement of the liability standards applicable to investment advisers by stating that CCM would only be liable for its own acts of gross negligence or willful misconduct.

Without admitting or denying the findings, CCM agreed, among other things, to pay disgorgement of $66,635 plus interest, pay a civil monetary penalty of $300,000 and retain an independent compliance consultant.

In the Matter of Comprehensive Capital Management, Inc., SEC Admin. Proc. File No. 3-20700 (Jan. 11, 2022), available at: https://www.sec.gov/litigation/admin/2022/ia-5943.pdf.

Litigation

SEC Wins Rare Jury Trial Against Adviser Over 12b-1 Fees

The SEC brought an action in the U.S. District Court for the Eastern District of Pennsylvania alleging that an investment adviser, Ambassador Advisors, LLC ("Ambassador"), invested its discretionary client accounts in mutual fund share classes with 12b-1 fees when lower-cost share classes were available. The mutual funds in which Ambassador invested its clients distributed the 12b-1 fees to broker-dealers, one of which had an arrangement with Ambassador whereby the broker would pass 95% of the fee back to Ambassador. As a result, over a four-year period between 2014 and 2018, Ambassador collected more than $1 million in revenue of which, according to the SEC, it generated at least $777,000 of those fees when lower cost non-12b-1 share classes were available for the same mutual fund.

The complaint arose out of the SEC's share class disclosure initiative where the SEC, in 2018, opened a window for investment advisers to self-report these types of mutual fund conflicts with reassurances from the SEC that it would recommend favorable settlement terms. Thereafter, the SEC has aggressively pursued cases against those firms, including Ambassador, that did not take part in self-reporting, the vast majority of which have settled with the SEC rather than face the costs and consequences of litigation.

In the opinion granting partial summary judgment, the Court noted that Ambassador did not disagree that its 12b-1 compensation arrangement presented a conflict of interest. Rather, it argued that it had adequately disclosed these conflicts in its Form ADV brochures and advisory agreement as well as trade confirmations and client account statements that clients received from their brokers after their transactions had been executed. However, the SEC argued that Ambassador did not specify the amount of the 12b-1 fees it was collecting on behalf of its clients' investments. Furthermore, it did not unequivocally disclose that it was collecting its clients' 12b-1 fees but instead disclosed that it "may" collect such fees. Finally, Ambassador did not disclose to its clients that they were eligible for non-12b-1 fee bearing share classes with lower fees or that Ambassador was intentionally forgoing those lower fee share classes in order to collect a fee.

After an eight-day trial, the jury ruled in favor of the SEC, finding that Ambassador breached its fiduciary duties in connection with its mutual fund share class selection practices. In a statement released after the verdict was entered, the SEC's Division of Enforcement Director Gurbir S. Grewal expressed pleasure with the verdict, noting that:

> investment advisers have fiduciary duties to act in their client's best interest, to seek best execution of client transactions, and to fully and fairly disclose all material facts relating to conflicts of interest. And when they don't, as the jury found today, they put their clients at risk. That's why we will continue to pursue investment advisers who breach their fiduciary obligations.

In an unusual turn of events, the day after the verdict was entered, the Court rescinded the verdict, writing that "[t]he judgment was entered prematurely," and that final judgment would be entered once the Court has resolved the SEC's requests for relief, including whether to grant disgorgement of ill-gotten gains.

Partial Summary Judgment Opinion, *SEC v. Ambassador Advisors, LLC*, Civil 5:20-cv-02274-JMG (E.D. Pa. Dec. 20, 2021).

SEC v. Ambassador Advisors, LLC, Civil 5:20-cv-02274-JMG (E.D. Pa. Mar. 23, 2022).

Class Action Suit Filed in Connection With Mutual Fund Collapse

Investors filed a class action lawsuit against, among others, Trust for Advised Portfolios (the "Trust"), a registered investment company, its investment adviser, Infinity Q Capital Management ("Infinity Q"), and its board of trustees (collectively, the "Defendants") for securities fraud, alleging pricing manipulation and material misrepresentation of the net asset values of a series fund of the Trust and its parallel hedge fund both managed by Infinity Q. The suit was filed one day after the U.S. Department of Justice indicted Infinity Q's founder and chief investment officer, James Velissaris, for allegedly inflating Infinity Q Fund assets by over $1.0 billion and falsifying records. Velissaris was also charged with wire fraud and lying to auditors. Civil charges were also filed against Velissaris by the SEC and CFTC. Investors claim massive losses caused by the pricing manipulation and misrepresentations and now seek to recoup those losses.

The funds were marketed to shareholders seeking "moderate growth" and "asymmetric returns" through the use of a swap strategy intended to preserve capital. The SEC alleges that Infinity Q was able to attract billions of dollars from investors by touting the ability of the funds to provide investors with exposure to alternative strategies used by hedge fund and private equity investors. Importantly, Infinity Q used third-party pricing service models to price these alternative investments for the purpose of calculating the funds' daily net asset values. However, according to the complaint, Infinity Q was manipulating these models to inflate the net asset value of the funds from 2017 to 2021. During this same period, the funds' marketing materials described robust valuation procedures, methodologies and controls utilized by the funds to ensure accurate pricing of the funds' holdings. Despite the funds' disclosure, Infinity Q personnel allegedly intentionally mismarked the funds' assets to make their net asset values appear artificially higher. As examples, the Complaint alleges that one reported valuation was "mathematically impossible" and another "defied logic." Therefore, the nonsensical nature of the valuations indicate that each of the Defendants, including the board of trustees of the mutual fund who had responsibility for determining the fair value of the fund's securities in good faith, knew, or should have known, that the funds' net asset values were fraudulent.

In February 2021, Infinity Q unexpectedly halted redemptions to investors stating that it could not continue to value holdings after two whistleblowers filed complaints with the SEC, which prompted the SEC to commence an

investigation. Thereafter, the SEC issued an exemptive order to the mutual fund and investors of the hedge fund were notified that the funds would continue to deny redemptions and liquidate their assets, leading to “one of the most egregious investment fund collapses in history wherein the funds lost over 40% of their respective values.” Specifically, each Fund’s net asset value had been overstated by $500 million from its last reported net asset value. Investors claim that they remain unable to withdraw their remaining money from the funds, which is being held back to cover fund expenses, and that fund assets are being depleted while they wait. This lawsuit now seeks to hold the Defendants liable for such losses.

Complaint, *Schiavi v. Infinity Q Capital Mgmt.*, Case 1:22-cv-00896 (E.D.N.Y. Feb. 17, 2022).

SEC Remarks

Chair Gensler Addresses Cybersecurity and Possible Regulatory Updates

In a January 24, 2022 speech, SEC Chair Gary Gensler expressed that given the continued rise of cybersecurity incidents and the ever evolving cybersecurity risk landscape, the SEC remains focused on improving the overall cybersecurity defense of the financial sector as well as its resiliency. Gensler noted that he thinks about cybersecurity policy at the SEC in three ways: cyber hygiene and preparedness; government reporting of cyber incidents; and, in certain cases, public disclosure.

Gensler first noted that he sees an opportunity to revisit Regulation Systems Compliance and Integrity ("Reg SCI"), which, adopted in 2014, covers a subset of large registrants like stock exchanges, clearinghouses, and self-regulatory organizations. Reg SCI helps ensure these large entities have sound technology programs, business continuity plans, testing protocols, and data backups. Gensler stated that he has asked the SEC Staff to review how the SEC might broaden the rule, for example, by possibly applying Reg SCI to other entities not currently covered, including broker-dealers. Gensler also stated that he has asked the Staff to make recommendations for the SEC's consideration around how to strengthen cybersecurity hygiene and incident reporting for a broader group of financial sector registrants, like investment companies, investment advisers, and broker-dealers, not covered by Reg SCI.

With regards to data privacy, Gensler also sees an opportunity to modernize Reg S-P, which requires broker-dealers, investment companies, and investment advisers to protect customer records and information. In particular, he has asked the Staff for recommendations on how "customers and clients receive notifications about cyber events when their data has been accessed, such as their personally identifiable information." Reforms might include proposing to alter the timing and substance of notifications currently required under Reg S-P.

On public companies, Gensler has asked the Staff to make recommendations around companies' cybersecurity practices and cyber risk disclosures—which may include their practices with respect to cybersecurity governance, strategy, and risk management—and whether and how to update disclosures to investors when cyber events have occurred.

Noting that service providers provide critical services to SEC financial sector registrants but are not typically registered with the SEC, Gensler has asked the Staff to also make recommendations to address the cyber risks unique to the services they provide. This may include holding SEC registrants accountable for their service

providers' cybersecurity programs as they relate to protecting against inappropriate access and shareholder information.

Gary Gensler, SEC Chair, Speech, *Cybersecurity and Securities Laws* (Jan. 24, 2022), available at: https://www.sec.gov/news/speech/gensler-cybersecurity-and-securities-laws-20220124.

Birdthistle's First Address as Director Hints at Possible Regulation to Come

In his first address as Director of the SEC's Division of Investment Management, William Birdthistle addressed what he sees as "financial fracture" in the "ecosystem of entities" that provide services to investment advisers and their clients. Such entities include "index providers, valuation services, model providers, risk managers, data analysts" as well as others. In his remarks, Birdthistle potentially calls for the registration of these entities, saying, "if these service providers are not registered with the SEC, then their performance of critical responsibilities for advisers may constitute an unwelcome disintegration of important protections that could result in harm to investors."

Turning his attention to crypto, he stated that he is cognizant of questions about how providing advice regarding crypto assets impacts compliance with the custody requirements under the Advisers Act. In light of this, Birdthistle noted that he is examining ways "to bring order" to crypto assets and the growing use of digital technology.

William Birdthistle, SEC Director of Division of Investment Management, Speech, *Remarks at the IAA Investment Adviser Compliance Conference* (Mar. 3, 2022), available at: https://www.sec.gov/news/speech/birdthistle-remarks-iaa-investment-adviser-compliance-conference-030322.

Director Birdthistle Questions Whether Section 36(b) Duty Is Being Honored

On March 28, 2022, William Birdthistle, SEC Division of Investment Management Director, gave remarks at the ICI Investment Management Conference where he touched on the fact that no plaintiff has ever won a Section 36(b) case. He highlighted that Section 36(b) of the Investment Company Act is not limited to shareholder actions, noting that the provision also gives the SEC the right to bring an action against a fund adviser that has allegedly breached its fiduciary duty, but only with respect to the receipt of compensation. The fact that no plaintiff has ever won a Section 36(b) case left Birdthistle questioning "whether the duty enacted in the statute is

truly being honored [if no adviser can lose].” His remarks have left the industry questioning the intent of his remarks and whether the SEC may start bringing actions under Section 36(b).

William Birdthistle, SEC Director of Division of Investment Management, Speech, *Remarks at the ICI Investment Management Conference* (Mar. 28, 2022), available at: https://www.sec.gov/news/speech/birdthistle-remarks-ici-investment-management-conference-032822.

SEC Addresses Evaluation of Materiality for Financial Reporting Errors

On March 9, 2022, Paul Munter, SEC Acting Chief Accountant, released a statement discussing the SEC Staff’s views on evaluating the materiality of errors in previously-issued financial statements. Securities laws require public companies to provide investors with accurate financial statements that comply with generally accepted accounting principles (GAAP). If an error is identified in previously-issued financial statements, investors must be notified that the financial statements were flawed. The manner in which investors are informed of the error depends on whether the error is deemed material. In the statement, Munter asserted that registrants, auditors and audit committees should take a “well-reasoned, holistic, objective approach from a reasonable investor’s perspective based on the total mix of information” when assessing whether an error is material. This determination should take into account “all relevant facts and circumstances surrounding the error, including both quantitative and qualitative factors.”

If an error is deemed material, the registrant is required to correct the error and reissue the prior-period financial statements, which is referred to colloquially as a “Big R” restatement. If the error is not material to the prior-period financial statements but would be material to the current period, the registrant must still correct the error in the current financial statements by restating the prior-period information and disclosing the error. This method of error correction is referred to as a “little r” restatement.

Munter noted that while there was a decline in the total number of restatements from 2013 to 2020, the Staff observed an increase in the number of “little r” restatements. The Staff believes that this increase may be partly attributed to flawed materiality assessments that place more importance on qualitative factors. Munter highlighted the need for an unbiased objective analysis that is consistent with a reasonable investor’s perspective, especially when assessing qualitative factors. He noted that registrants using flawed processes end up correcting the error with a “little r” restatement when they should be reissuing the prior period’s financial statements. The Staff plans to continue monitoring restatement trends to learn more about how accounting errors are corrected and ensure registrants are providing investors with accurate financial statements.

Paul Munter, SEC Acting Chief Accountant, *Assessing Materiality: Focusing on the Reasonable Investor When Evaluating Errors* (Mar. 9, 2022), available at: https://www.sec.gov/news/statement/munter-statement-assessing-materiality-030922.

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