Simpson Thacher

Registered Funds Regulatory Update

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SEC Rulemaking

Proposed Amendments to the Funds Names Rule (Rule 35d-1)

The SEC voted to propose amendments to Rule 35d-1 under the Investment Company Act, the so-called "Names Rule." The existing Names Rule requires a fund with a name that suggests a focus in a particular type of investments or industry to adopt a policy to invest at least 80% of the value of its assets in accordance with the focus that the fund's name suggests (an "80% test"). The existing rule has led to confusion as SEC staff have taken inconsistent positions as to whether certain terms connote a type of investment or investment in a particular industry (which would require an 80% test) or an investment strategy (which would not). The SEC acknowledged these determinations are subjective, not mutually exclusive, and prone to second guessing. Accordingly, the proposed amendments would broaden the scope of the Names Rule to require an 80% test for any fund that includes terms in its name suggesting that the fund focuses in investments that have, or whose issuers have, particular characteristics, including fund names with terms indicating that the fund's investment decisions incorporate one or more ESG factors. Most importantly (and confusing), the proposal would apply the Names Rule to terms that do not have an obvious or widely-agreed definition, such as "value" and "growth," and ESG-related terms, such as "sustainable," "green," or "socially responsible." It would also apply to names that have not historically fallen under the Names Rule, such as "global," "international," and "income."

Recordkeeping and Reporting: Funds that do not adopt an 80% investment policy would be required to maintain a written record of their analysis that such a policy is not required under the Names Rule. A fund that does adopt an 80% investment policy must define the terms used in its name that require the 80% investment policy and determine whether each investment in its portfolio counts toward its 80% bucket and report that holdings-level information monthly on Form N-PORT.

Derivatives: On a positive note, the proposal would require funds to use a derivative instrument's notional amount, rather than its market value, for purposes of determining a fund's compliance with its 80% investment policy. Under the proposed rule, a fund may include in its 80% basket the notional amount of derivatives instruments that provide exposure to (i) investments suggested by the fund's name; or (ii) market risk factors associated with such investments.

Departures from an 80% policy: The current rule states that a fund must comply with its 80% test under "normal circumstances" and requires a fund to determine compliance with its 80% test when it enters into each new investment. The proposal, by contrast, imposes a continuous obligation for a fund to monitor compliance with its 80% test and only permits a fund to depart from its 80% policy under certain specified circumstances for no more than 30 consecutive days.

Unlisted CEFs and BDCs: Under the proposal, unlisted closed-end funds and BDCs would not be permitted to change their 80% investment policies without shareholder approval. Specifically, the proposal would require that unlisted CEFs adopt an 80% test under Section 8(b)(3) of the Investment Company Act. For BDCs, the proposal would require that the 80% test be changeable only by the vote of a majority of its outstanding voting securities.

Comments on the proposal are due August 16, 2022 and, if adopted, the rule amendments would have a one year implementation period. SEC Chair Gary Gensler and SEC Commissioners Allison Herren Lee and Caroline Crenshaw voted for the proposal, while SEC Commissioner Hester Peirce voted against.

Investment Company Names, SEC Rel. No. IC-34593 (May 25, 2022), available at: https://www.sec.gov/rules/proposed/2022/ic-34593.pdf.

ESG Disclosures for Investment Companies and Investment Advisers

The SEC voted to propose new ESG disclosure requirements for investment companies and investment advisers. The proposal would require funds and advisers that consider ESG factors in their investment processes to disclose additional information about their ESG analyses and activities. The amount and specificity of the required disclosure depends on the extent to which a fund considers the weight given to the ESG factors in its investment process.

Funds: The proposal categorizes ESG funds into three buckets:

- *Integration Funds* – Funds that integrate ESG factors alongside non-ESG factors in investment decisions would be required to describe how ESG factors are incorporated into their investment process. The proposal omits any materiality threshold for integration funds, indicating that any fund that considers one or more ESG factors alongside other non-ESG factors in investment decisions would qualify as an ESG fund. Taken to its extreme, a fund that considers thousands of investment signals, a handful of which relate to "E", "S" or "G" factors, would fall within the ambit of the Integration Fund regulation.
- *ESG-focused funds* – Funds for which ESG factors are a significant or main consideration would be required to provide detailed disclosure, including a standardized ESG strategy overview table.
- *Impact funds* – ESG-focused funds that seek to achieve a particular impact would be required to disclose how they measure progress on their objectives, including information about proxy voting and issuer engagement, as applicable.

These categories appear to be designed to be consistent with the fund categorization called for by the Financing for Sustainable Development, and the proposal imposes specific disclosure requirements for each category.

Advisers: Advisers that consider ESG factors would be required to make generally similar disclosures in their brochures describing any ESG criteria or methodologies used in their investment strategies, including details

about the adviser's use of any internal methodologies, external providers or frameworks, inclusionary or exclusionary screens, or indices. As with funds, advisers that seek a specific ESG impact must describe any progress toward the stated impact.

Green House Gas Emissions Reporting: Likely the most controversial aspect of the proposal is a new framework for climate-related disclosures by registered funds. The proposed framework builds on the SEC's March 2022 rule proposal to establish a new framework for climate-related disclosures for public company issuers. The fund proposal would require ESG-focused funds that consider environmental factors in their investment process to report both the carbon footprint and the weighted average carbon intensity of their portfolio, which the proposal sets forth a detailed methodology for calculating. Because much of the data that supports the calculations is not publicly available or reliable, a fund may use a good faith estimate of a portfolio company's emissions if it is unable to identify publicly available information after a reasonable search. If a fund uses a good faith estimate, it must describe how it calculated the estimate and the sources of data underlying the calculation. Due to the scarcity of existing data, it appears that the proposal could result in funds with similar portfolios reporting different results. The burden of these reporting requirements are also likely to have a chilling effect on the use of ESG-focused investment strategies by registered funds.

Comments on the proposed requirements are due on August 16, 2022.

Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices, SEC Rel. No. IA-6034 (May 25, 2022), available at: https://www.sec.gov/rules/proposed/2022/ia-6034.pdf.

SEC Requests Comment on Activities of Index Providers, Model Portfolio Providers and Pricing Services

On June 15, 2022, the SEC requested information and public comments (the "Request for Comment") on matters related to the activities of index providers, model portfolio providers and pricing services (collectively, "information providers"). The Request for Comment primarily focuses on the activities of the information providers to determine whether they should fall under the definition of an "investment adviser" under the Advisers Act thereby requiring registration.

By way of background, index providers compile, create the methodology for, sponsor, administer and/or license market indexes; model portfolio providers create model portfolios generally consisting of diversified groups of assets (often mutual funds or ETFs) designed to achieve a particular expected return with exposure to corresponding risks; and pricing services provide pricing, valuation and additional data about particular investments to assist funds in determining appropriate valuations. Given the increasing role of information providers in the asset management industry, information providers may have the ability to affect national

markets, which raises concerns related to sufficient investor protection and market risk. For instance, the operation of these information providers may increase the potential for front-running trades where the information providers and their personnel have advance knowledge of information and conflicts of interest where the information providers and their personnel hold investments that they value or that are constituents of their indexes or models.

The Request for Comment includes specific questions related to the information providers' registration status under the Advisers Act, including, among others:

- how information providers analyze whether they meet the Advisers Act's definition of "investment adviser," including whether they rely on the "publisher's exclusion" or other exclusions;
- whether the regulatory status of information providers developing broad-based indexes should differ from those developing customized or bespoke indexes;
- to what extent information providers view themselves as having fiduciary obligations to any investors that rely on the information they provide (*e.g.*, when investors receive such information through another financial professional);
- to what extent information providers exercise discretion in providing information or establishing and updating information;
- how information providers are compensated;
- how information providers address potential conflicts of interest;
- whether there should be an exemption from the prohibition against registration for information providers that do not have regulatory assets under management but that have a "national presence" or can have a significant effect on the national markets; and
- whether any U.S. regulatory action should be aligned with the framework for index providers under the EU Benchmarks Regulation.

To the extent that information providers' activities may constitute investment advice and require registration under the Advisers Act, information providers would be subject to substantive prohibitions and requirements, including contractual requirements, recordkeeping obligations, compliance programs and SEC oversight, including periodic filings and inspection. Notably, the SEC staff recognized that some information providers may not fit neatly into the existing regulatory structure, and, to that end, requested comment on whether certain regulatory requirements should be specifically tailored to the operations and services of information providers.

In addition to the implications under the Advisers Act, the Request for Comment notes that certain information providers may be acting as an "investment adviser" of an investment company under the Investment Company Act. For example, an index provider, particularly to the extent the index provider maintains a bespoke index created for a single fund, could meet the definition of an investment adviser to a fund under the Investment

Company Act, if no exception applies. Such status would trigger significant regulatory requirements, obligations and limitations, including requirements for fund board and shareholder approval of the investment adviser's advisory contract, as well as prohibitions on self-dealing and other types of overreaching of a fund by its affiliates, and requirements related to the approval of compliance policies and procedures by the fund's board.

In response to such implications, the Request for Comment includes specific questions on certain aspects of the Investment Company Act, including:

- how information providers analyze whether they meet the Investment Company Act's definition of "investment adviser;"
- to what extent information providers directly contract with funds;
- to what extent information providers distribute uniform publications (an existing exclusion to the definition of investment adviser); and
- to what extent funds currently extend their compliance programs to information providers.

Following the release of the Request for Comment, SEC Chair Gary Gensler issued a statement in support of the Request for Comment highlighting that these information providers are becoming increasingly influential in today's markets, which "raises important questions under the securities laws as to if they are providing investment advice rather than merely information." Gensler also noted that the market may benefit from further guidance given the advances in the asset management industry and the lack of guidance on the definition of "investment adviser" since the 1980s and 1990s. SEC Commissioner Caroline Crenshaw also issued a statement in support of the Request for Comment, noting that "many information providers appear to exercise significant discretion in the performance of their services" and their increasing prominence in the industry "adds import to the consideration of whether and how the framework for registering and regulating investment advisers should apply in the context of information providers."

Comments are due August 16, 2022.

Request for Comment on Certain Information Providers Acting As Investment Advisers, SEC Release No. IA-6050 (June 15, 2022), available at: https://www.sec.gov/rules/other/2022/ia-6050.pdf.

Unclogging the Plumbing—SEC Proposes to Shorten Securities Settlement Cycle to One Business Day ("T+1")

On February 9, 2022, the SEC proposed to shorten the standard settlement cycle for securities transactions from two business days after trade date ("T+2") to one business day after trade date ("T+1"). Proposed Rule 15c6-2 under the Exchange Act is part of a broader response by the SEC to mitigate systemic vulnerabilities to the financial markets posed by the COVID-19 pandemic along with the "meme" stock trading frenzy that occurred last

year. The release also notes that, while not currently proposed, the SEC is "actively assessing" a future movement to a same-day standard settlement cycle ("T+0"). The following highlights the direct impacts to settlements that will result if Rule 15c6-2 is adopted as proposed:

1. The SEC is proposing to reduce the settlement timeline for most broker-dealer transactions from T+2 to T+1.

2. Under the existing rule, firm commitment offerings priced after 4:30 p.m. ET are permitted to be considered as made on the next trading day and then allowed to settle on a three business day ("T+3") timeline (effectively four business days, or "T+4," from the time of the trade). The current proposal would now require these offerings to close the next day—shortening what was effectively a settlement cycle of T+4 to T+1.

3. Under what is commonly known as the "override provision," the existing rule provided for important flexibility allowing for parties to expressly consent at the time of the trade that the settlement date would occur later than T+2. The SEC is not proposing to remove this flexibility, which will still provide an important carve-out for instances that a T+1 settlement would be impracticable. However, the SEC noted that the override provision was intended to apply only to unusual transactions, such as option trades that typically settle 60 days after execution, although in practice, the override provision has been used broadly in debt offerings.

4. Investment advisers that effect block-trades for the accounts of several customers simultaneously have been required to provide post-trade underlying account allocation instructions to the broker or custodian before these transactions are allowed to settle. Certain other transactions, primarily involving institutional trades, require post-trade exchange of confirmations and affirmations, in order for the parties to compare trade details and facilitate settlement with third-party custodians. While these processes are often completed on the trade date, that is not always the case. Under Rule 15c6-2, to facilitate next-day settlement (T+1), all broker-dealers and their institutional customers will now also be required to agree to allocate, confirm, and affirm the trade details by the end of the trade date.

5. The proposal also seeks to amend the books and records rule under the Advisers Act to require advisers who are parties to a contract under Rule 15c6-2 to maintain the records of each confirmation received and any allocation and each affirmation sent. Advisers would be required to keep the original documentation of confirmations along with copies of allocations and affirmations, however, such records are permitted to be maintained electronically if certain conditions are satisfied.

6. In connection with proposed Rule 15c6-2, the SEC has also proposed new Rule 17Ad-27 under the Exchange Act for central matching service providers ("CMSPs"). CMSPs are providers that electronically facilitate communication among a broker-dealer, an institutional investor or its investment adviser, and the institutional investor's custodian to reach agreement on the details of a securities trade. Rule 15c6-2 would require CMSPs to establish, implement, maintain and enforce policies and procedures to facilitate "straight-through processing" for transactions involving broker-dealers and their customers. Straight-through

processing generally refers to processes that allow for the automation of the entire trade process—from trade execution through settlement—without manual intervention. The new proposal would require CMSPs to implement holistic policies and procedures that minimize or eliminate, to the greatest extent technologically feasible, the need for any manual input of trade details or other manual intervention to resolve errors that can prevent delays in trade-settlement.

Shortening the standard settlement cycle to T+1 will also have certain follow-on effects on a number of other rules and market practices that are themselves intertwined with the standard settlement cycle, such as various self-regulatory organization (SRO) requirements and other rules that reference the settlement time period.

While the proposal is a progression of the broader historical push by the SEC towards a shortened settlement cycle, a shift to a next-day settlement cycle under proposed Rule 15c6-2 is likely to impose substantial technological and logistical hurdles for the entire financial and securities industries. Comments on the proposal were due on April 11, 2022.

Shortening the Securities Transaction Settlement Cycle, SEC Release No. 34-94196, available at: https://www.sec.gov/rules/proposed/2022/34-94196.pdf.

SEC Announces Spring 2022 Regulatory Agenda

On June 22, 2022, the SEC's Office of Information and Regulatory Affairs released the Spring 2022 Unified Agenda of Regulatory and Deregulatory Actions that includes the Division of Investment Management's anticipated short- and long-term regulatory actions. According to the SEC, the proposed Agenda seeks to (i) continue to drive efficiency in the capital markets; and (ii) modernize rules for today's economy and technologies. The Agenda includes:

- rule amendments to enhance registrant disclosure of board and nominee diversity;
- rule amendments pertaining to shareholder proposals under Rule 14a-8 under the Exchange Act;
- rule amendments and/or proposed new rules under the Advisers Act to improve and modernize the regulations around the custody of assets;
- new streamlined shareholder reporting under the Investment Company Act and adoption of rule and form amendments to improve and modernize certain aspects of the current disclosure framework under the Investment Company Act;
- proposed rules to implement Section 953(a) of the Dodd-Frank Act, which added section 14(i) to the Exchange Act requiring issuers to disclose information setting forth the relationship between executive compensation paid and the financial performance of the issuer;

- rule amendments to address concerns around the use of the affirmative defense provisions of Exchange Act Rule 10b5-1 that would add new conditions designed to address abuse of the rule to opportunistically trade securities on the basis of material nonpublic information in ways that harm investors and undermine the integrity of the securities markets; and
- changes to regulatory requirements relating to registered investment companies' fees and fee disclosure.

Following the release of the Request for Comment, SEC Commissioner Hester Peirce issued a statement criticizing the Agenda for failing to "include any items intended to facilitate capital formation." Peirce stated that the Agenda contradicts what she sees as the agency's policy missions: (i) to disclose economically material information; (ii) protect retail investors; (iii) help small and emerging companies raise funds; and (iv) increase the number of public companies. She noted, "[we] can avoid creating regulatory rip currents by recalibrating our agenda to focus on issues core to the protection of investors and operation of our markets and by slowing down the pace to ensure that we and the public can think about what we are doing."

SEC Press Release, *SEC Announces Spring 2022 Regulatory Agenda* (June 22, 2022), available at: https://www.sec.gov/news/press-release/2022-112.

Hester M. Peirce, SEC Commissioner, Statement, *Rip Current Rulemakings: Statement on the Regulatory Flexibility Agenda* (June 22, 2022), available at: https://www.sec.gov/news/statement/peirce-statement-regulatory-flexibility-agenda-062222.

SEC Staff Guidance

SEC Addresses Investment Adviser MNPI and Code of Ethics Compliance Issues

On April 26, 2022, the SEC's Division of Examinations issued a Risk Alert describing notable deficiencies related to Section 204A of the Advisers Act and Rule 204A-1 thereunder. Section 204A of the Advisers Act requires investment advisers to adopt written compliance policies and procedures that are designed to prevent the misuse of material non-public information ("MNPI") whereas Rule 204A-1 requires advisers to adopt a code of ethics that sets forth the standards of business conduct expected from the adviser's supervised persons. The Risk Alert described certain common deficiencies with respect to advisers' compliance policies and procedures and codes of ethics.

Consistent with the general trend toward a more expansive SEC view of what constitutes MNPI as reflected in several recent enforcement actions—certain of which are alluded to but not cited in the Risk Alert—the Risk Alert reflects heightened regulatory expectations with respect to how advisers monitor their intake and treatment of MNPI at both the firm and employee level. Specifically, the Staff observed inadequate adoption or implementation of Section 204A compliance policies and procedures with respect to:

- the potential receipt and use of MNPI from non-traditional data sources (*e.g.*, social media, internet search data, and satellite imagery), including deficient diligence processes (including periodic diligence subsequent to on-boarding), as well as failures to memorialize implementation of applicable policies;
- the identification of, and tracking of relationships with, "value-add" investors or key persons who are likely to possess MNPI, such as officers or directors of a public company; and
- tracking communications with expert network consultants who may be related to publicly traded companies or have access to MNPI, and associated trading activity.

The Risk Alert also identified common deficiencies related to an adviser's code of ethics, including:

- failing to identify all access persons;
- access persons failing to obtain pre-approval for investments in initial public offerings or limited offerings;
- failing to follow reporting requirements for personal securities transactions and holdings;
- failing to provide a copy of the code of ethics or obtaining written acknowledgment of receipt of the code;
- trading of securities that are on the adviser's restricted list; and
- failing to allocate investment opportunities in accordance with the written code of ethics.

Investment Adviser MNPI Compliance Issues, Division of Examinations, SEC (April 26, 2022), available at https://www.sec.gov/files/code-ethics-risk-alert.pdf.

Industry Developments

FINRA Explains Sales Practices Obligations for Alternative Funds

On April 19, 2022, FINRA issued a Regulatory Notice reminding member firms of their sales practice obligations for alternative mutual funds ("Alt Funds"), which FINRA defined in the Notice as open-end registered investment companies that seek to achieve their objective through investments in non-traditional investments or asset classes. The Notice summarized FINRA's recent observations and enforcement actions related to Alt Fund sales practices and reminded member firms of previous FINRA guidance on this topic.

FINRA noted that recent examinations revealed inadequate written supervisory procedures, inadequate oversight, and insufficiently reviewed public communications related to Alt Fund sales. FINRA also conducted several recent enforcement actions related to sales of Alt Funds, finding that member firms failed to:

- conduct reasonable diligence regarding the risks and features of Alt Funds;
- maintain reasonably designed supervisory systems to review recommendations of Alt Funds;
- provide reasonable guidance to representatives regarding Alt Funds; and
- maintain written supervisory practices advising firm principals how to supervise recommendations of Alt Funds.

The Notice also provided a list of effective practices that some member firms have used to address the risks and characteristics of Alt Funds, including:

- implementing policies and procedures that require review and approval of new Alt Funds;
- documenting and maintaining records of diligence of Alt Fund strategies and metrics;
- restricting recommendations of Alt Funds based on Alt Fund strategy or investor category;
- applying a heightened level of review to Alt Fund transactions through existing or new monitoring systems and triggering exceptions at lower concentration levels for Alt Funds;
- requiring enhanced principal review for Alt Fund transactions;
- reevaluating approved funds lists to identify whether any product should be categorized as an Alt Fund;
- training staff members on Alt Funds and providing relevant regulatory guidance; and
- voluntarily filing proposed retail communications concerning new Alt Funds with FINRA and incorporating FINRA feedback prior to using the communications.

FINRA Reminds Firms of Their Sales Practice Obligations for Alternative Mutual Funds, FINRA Regulatory Notice 22-11, available at: https://www.finra.org/rules-guidance/notices/22-11.

SEC's Crypto Assets and Cyber Unit Nearly Doubles in Size

On May 3, 2022, the SEC announced it was adding 20 positions to the Division of Enforcement's Crypto Assets and Cyber Unit, formerly called the Cyber Unit, bringing the Unit's total headcount to 50 dedicated supervisors, investigative staff attorneys, trial counsels, and fraud analysts. Since its creation in 2017, the Unit has brought more than 80 enforcement actions related to fraudulent and unregistered crypto asset offerings and platforms. The Unit has also brought numerous actions against SEC registrants and public companies for failing to maintain adequate cybersecurity controls and appropriately disclose cyber-related risks and incidents.

The announcement highlights the SEC's focus on cyber-related threats and added scrutiny of securities law issues related to crypto, including asset offerings and exchanges; asset lending and staking products; decentralized finance platforms; non-fungible tokens; and stablecoins.

SEC Division of Enforcement, Press Release, *SEC Nearly Doubles Size of Enforcement's Crypto Assets and Cyber Unit* (May 3, 2022), available at: https://www.sec.gov/news/press-release/2022-78.

FINRA Issues Notice Regarding "Complex" Exchange-Traded Products

On March 8, 2022, FINRA issued a Regulatory Notice reminding members of their sales practice obligations regarding complex products and soliciting comments on effective sales practices and rules to help mitigate risks for retail investors. FINRA highlighted the significant increase in retail trading of complex products and noted that complex products can affect underlying assets and operate in unanticipated ways when markets experience volatility or stress conditions.

FINRA reminded members of their responsibilities to scrutinize complex products and described sanctions it recently levied in relation to such products, including against members that:

- failed to reasonably supervise brokers' recommendations of leveraged, inverse, and volatility-linked ETPs, leading to unsuitable recommendations of these products that caused customer losses;
- failed to reasonably supervise a broker who recommended that customers liquidate their retirement accounts and invest the proceeds in speculative and illiquid securities;
- failed to reasonably supervise a broker who recommended that customers concentrate their accounts in an inverse floating rate collateralized mortgage obligation, resulting in more than $2 million in losses; and

- recommended concentrated investments in high-risk business development companies, resulting in more than $1 million in losses.

FINRA also included a request for comment on several questions related to the increase in, and risks of, retail trading of complex investment products.

FINRA Reminds Members of Their Sales Practice Obligations for Complex Products and Options and Solicits Comment on Effective Practices and Rule Enhancements, FINRA Regulatory Notice 22-08, available at: https://www.finra.org/rules-guidance/notices/22-08#notice.

Senate Confirms Two New SEC Commissioners

On June 16, 2022, the Senate unanimously confirmed Jamie Lizárraga and Mark Uyeda as SEC Commissioners. Both Lizárraga and Uyeda were nominated by President Joe Biden on April 6, 2022.

Lizárraga will replace SEC Commissioner Allison Herren Lee upon her departure in June and will serve until June 2027. For the past 14 years, Lizárraga has worked on House of Representatives Speaker Nancy Pelosi's staff. Before that, Lizárraga was a member of the House Financial Services Committee, and during the Clinton administration, he held appointments at the Treasury Department and SEC.

Uyeda will replace former SEC Commissioner Elad Roisman, who departed the SEC in January, and will serve until June 2023. Uyeda has worked as an SEC lawyer for the past 15 years and currently is on detail as Republican counsel to the Senate Banking Committee. Since joining the SEC in 2006, Uyeda has worked as a senior adviser to Chairman Jay Clayton and Acting Chairman Michael Piwowar and as an assistant director and senior special counsel in the SEC's Division of Investment Management, among other roles.

Statement*, Statement on Senate Confirmation of Jaime Lizárraga and Mark Uyeda* (June 16, 2022), available at: https://www.sec.gov/news/statement/commissioners-statement-confirmation-lizararago-uyeda.

Legislative Developments

Too Narrow to Succeed Act Aims to Diversify Asset Management Industry

A bill was recently introduced in the Senate and House of Representatives that is intended to improve access for diverse-owned asset management firms. The bill, known as the Too Narrow to Succeed Act, would:

- increase transparency on how federal institutional investors (as defined in the bill, and including entities such as the Federal Retirement Thrift Investment Board) select asset management firms;
- identify barriers that limit opportunities for diverse-owned firms and develop strategies to remove such barriers; and
- enable retirement funds to adopt a broader and more inclusive selection process to reduce risk and maximize returns.

If passed, federal institutional investors that use the services of an asset management firm to manage federal investments would be required to submit an annual report to the Secretary of Labor on the investor's use of diverse-owned asset management firms, including the amount of assets managed by non-diverse-owned asset management firms versus diverse-owned firms. The report would also need to note any challenges the federal institutional investor faced in selecting diverse-owned firms and the actions taken to increase opportunities for diverse-owned firms.

The bill also requires the Secretary of Labor to conduct a periodic survey of the best practices with respect to increasing the utilization and capacity of diverse-owned asset management firms and report the findings to Congress.

Too Narrow to Succeed Act, H.R. 7594, 117th Cong. (2022), available at: https://www.congress.gov/bill/117th-congress/house-bill/7594/text.

SEC Enforcement

Adviser Charged for Misrepresenting ESG Review Process of Certain Mutual Fund Portfolio Holdings

The SEC recently settled charges against BNY Mellon Investment Adviser, Inc. ("BNY Mellon"), a registered investment adviser, for material misstatements and omissions regarding its consideration of ESG principles in making investment decisions for certain mutual funds that it manages. The enforcement action comes after the SEC Division of Enforcement formed a Climate and ESG Task Force in March to analyze disclosure and compliance issues relating to investment advisers' and funds' ESG strategies.

The Order found that, from July 2018 to September 2021, BNY Mellon allegedly represented or implied in various statements and documents that all investments made by certain of its funds had undergone a proprietary ESG quality review process even though that was not the case. BNY Mellon made such representations to investors via prospectus disclosure and in responses to requests for proposals as well as to the funds' boards.

The funds involved in the SEC action are not part of BNY Mellon's suite of sustainable products, which follow certain ESG-related criteria as part of their principal investment strategies. Rather, the funds may incorporate ESG considerations into investment decisions, but do not have a specific mandate to follow ESG principles for any individual investment. BNY Mellon represented that the funds still went through the ESG quality review as part of the investment research process. However, the funds' sub-adviser made some investment decisions that were not vetted according to that ESG quality review. For example, in one fund, nearly 25% of the fund's net assets did not have an ESG quality review score as of the time of investment.

Without admitting or denying the findings, BNY Mellon agreed to a cease-and-desist order, a censure and a $1.5 million civil monetary penalty.

In the Matter of BNY Mellon Investment Adviser, Inc., SEC Admin. Proc. File No. 3-20867 (May 23, 2022), available at: https://www.sec.gov/litigation/admin/2022/ia-6032.pdf.

Adviser and Sub-Adviser Charged With Valuation Failures—Alleged Manipulation of Pricing Vendors' Valuation of Odd-Lot Bonds

The SEC settled charges against AlphaCentric Advisors LLC ("AlphaCentric") and Garrison Point Capital, LLC ("Garrison"), each a registered investment adviser, for compliance violations in their respective roles as adviser and subadviser to the AlphaCentric Income Opportunities Fund. An Order found that Garrison manipulated pricing vendor valuations causing the overvaluation of certain Fund securities and misled investors by providing

materially inaccurate information regarding sources of Fund performance. A separate Order found that AlphaCentric failed to adopt and implement fair valuation policies and procedures reasonably designed to oversee the role of Garrison in valuing the Fund's securities.

The Orders found that, from May 2015 through July 2015, Garrison purchased small "odd-lot" bonds for the Fund that often traded at a discount to larger round lots. Garrison valued these odd-lot bonds using the higher "round-lot" pricing provided by a third-party pricing vendor, which resulted in the Fund overstating its daily net asset value by over 7% during the relevant period.

The Orders also found that, from January 2017 to February 2019, Garrison manipulated pricing vendor fair valuation determinations. When Garrison believed a pricing vendor's marks were too low, it placed bids with certain broker-dealers to purchase the bonds at higher prices. Garrison then provided those bids as its own bids to the pricing vendor to persuade the vendor to increase its marks on the bonds. The Fund then priced its securities based on the increased marks. In several instances where Garrison submitted deceptive pricing bids, the Fund owned the entire tranche of bonds and could not have even purchased additional bonds. During this period, Garrison also provided the vendors with its own analysis of a bond's fundamental characteristics but when the pricing vendor did not consider its analysis, Garrison allegedly tried to change the valuation of many securities through its pricing bid tactic.

During this same period, AlphaCentric failed to adhere to its fair valuation policies and procedures, which required it to review the pricing of the Fund's holdings daily for reasonableness. It also failed to oversee Garrison's performance, its related communications with the pricing vendors, and Garrison's use of pricing bids. While these alleged violations related to the pricing of "odd-lot" securities are similar to allegations in other recent SEC enforcement actions, the prior actions did not involve a third-party sub-adviser structure where the investment adviser allegedly failed to oversee the sub-adviser's performance.

Without admitting or denying the SEC's findings, AlphaCentric and Garrison agreed to cease-and-desist orders, censures and civil monetary penalties in the amount of $300,000 and $3.5 million, respectively.

In the Matter of AlphaCentric Advisors, LLC, SEC Admin. Proc. File No. 3-20877 (June 3, 2022), available at: https://www.sec.gov/litigation/admin/2022/ia-6040.pdf.

In the Matter of Garrison Point Capital, LLC, SEC Admin. Proc. File No. 3-20876 (June 3, 2022), available at: https://www.sec.gov/litigation/admin/2022/ia-6039.pdf.

SEC Settles With Adviser for Alleged Short-Selling Restrictions Violations

The SEC recently settled charges against Weiss Asset Management LP ("WAM"), a registered investment adviser, for violating short-selling restrictions when it unlawfully purchased stock in seven public offerings after selling short those same stocks.

The Order found that on seven occasions between December 2020 and February 2021, WAM violated Rule 105 of Regulation M under the Exchange Act, which prohibits short selling an equity security during a restricted period and then purchasing the same security through the offering absent an exception. The Rule 105 restricted period is the shorter of the period: (i) beginning five business days before the pricing of the offered securities and ending with such pricing; or (ii) beginning with the initial filing of a registration statement or notification on Exchange Act Form 1-A or 1-E and ending with pricing.

The Order found that these violations occurred because WAM repeatedly miscalculated the restricted period as commencing after the firm's short sales and incorrectly dismissing red flags raised by the firm's Rule 105 controls that detected possible violations both before and after WAM participated in the offerings.

The Order highlighted WAM's significant remedial efforts and cooperation in the SEC staff investigation, including segregating the ill-gotten profits, updating its compliance and training efforts, and promptly self-reporting the seven violations to SEC staff following its own trading records review.

Without admitting or denying the findings, WAM agreed to cease-and-desist and disgorge profits of $6,508,793 plus interest and a civil monetary penalty of $200,000.

In the Matter of Weiss Asset Management LP, SEC Admin. Proc. File No. 3-20899 (June 14, 2022), available at: https://www.sec.gov/litigation/admin/2022/34-95099.pdf.

Litigation

Fifth Circuit Court of Appeals Vacates SEC Decision Questioning Constitutionality in SEC Procedure

The U.S. Court of Appeals for the Fifth Circuit (the "Court") vacated a decision by the SEC against George Jarkesy Jr. and Patriot28, LLC (together, the "Petitioners"). The Court held that (i) the SEC's in-house adjudication of Petitioners' case violated their Seventh Amendment right to a jury trial; (ii) Congress unconstitutionally delegated legislative power to the SEC by granting it full discretion to choose the judicial forum for enforcement actions without appropriate guidance; and (iii) statutory removal restrictions on SEC Administrative Law Judges ("ALJs") violated the Take Care Clause of Article II of the Constitution. For these reasons, the Court vacated the decision of the SEC and remanded the case for further proceedings.

While the holdings in *Jarkesy* raise important issues the Supreme Court may consider, the Supreme Court recently granted certiorari in a similar case—*SEC v. Cochran*. In *Cochran,* the Fifth Circuit ruled that Constitutional challenges to an administrative proceeding may continue in federal court prior to the conclusion of an administrative hearing. This same argument was made by the Petitioners in the U.S. District Court for the District of Columbia but was denied.

These developments may significantly affect the landscape of future SEC enforcement actions and should be considered as part of a strategy in defending SEC enforcement actions.

Background

Jarkesy established two hedge funds to which Patriot28 acted as the investment adviser. The SEC brought an administrative action against the Petitioners alleging that the Petitions committed fraud under the Securities Act, the Exchange Act and the Advisers Act. Specifically, the SEC charged that the Petitioners: (i) misrepresented who served as the funds' prime broker and auditor; (ii) misrepresented the funds' investment parameters and safeguards; and (iii) overvalued the funds' assets to increase the fees charged to investors. After evidentiary hearings, the ALJ concluded that Petitioners committed securities fraud. The Petitioners then sought review by the SEC, but the SEC affirmed the holding of the ALJ and ordered the Petitioners to cease and desist and pay disgorgement and a civil monetary penalty. Jarkesy was also barred from various securities industry activities.

Petitioners initially sued the SEC in the U.S. District Court for the District of Columbia to enjoin the agency's proceedings, arguing that the ALJ proceedings infringed upon their Constitutional rights. The District Court refused to issue an injunction and determined it lacked jurisdiction. This is in opposition to the decision in *Cochran*.

The SEC rejected several Constitutional arguments and determined that: (i) the ALJ was not biased against Petitioners; (ii) the Commission did not inappropriately prejudge the case; (iii) the Commission did not use unconstitutionally delegated legislative power—or violate Petitioners' equal protection rights—when it decided to pursue the case within the SEC enforcement regime instead of in an Article III court with a jury; (iv) the removal restrictions on SEC ALJs did not violate Article II and separation-of- powers principles; and (v) the proceedings did not violate Petitioners' Seventh Amendment right to a jury trial. Petitioners then filed a petition for review in federal court.

Holdings

UNCONSTITUTIONAL DENIAL OF JURY TRIAL

First, the Court held that "the SEC's enforcement action is akin to traditional actions at law to which the jury-trial right attaches." The Court explained that although Congress has the power to assign certain proceedings to administrative adjudication, such power is limited to proceedings involving public rights. Congress cannot assign the adjudication of such claims to an agency because such claims do not concern public rights alone.

In coming to this conclusion, the Court first examined whether the claims in the action arose "at common law" under the Seventh Amendment. Second, the Court examined if the Supreme Court's public-rights cases permit Congress to assign such cases to ALJs without a jury trial. The relevant factors considered were whether Congress created a new right of action and remedies unknown to common law and whether a jury trial would "dismantle the statutory scheme."

The Court determined that the rights the SEC sought to enforce did arise "at common law" under the Seventh Amendment, as fraud is a common law doctrine and the SEC sought a civil monetary penalty, which is a remedy under common law. In addition, the Court held that a jury trial would not "dismantle the statutory scheme" as the statutory scheme itself permits proceedings to be brought either before an ALJ or an Article III court. As such, securities fraud actions are not uniquely suited for ALJs.

Given the above, the Court held that Petitioners had the "right for a jury to adjudicate the facts underlying any potential fraud liability."

UNCONSTITUTIONAL DELEGATION OF LEGISLATIVE POWER

Second, the Court held that Congress unconstitutionally delegated legislative power to the SEC when it gave the SEC discretion to choose whether to bring enforcement actions in Article III courts or before an ALJ without providing the SEC with "intelligible principles to guide its use of the delegated power."

The Court explained that the Supreme Court has previously held that the power to assign disputes to agency adjudication is legislative in nature. The Court noted that when Congress delegates a legislative power it must offer an intelligible principle by which to exercise the power. The Court noted, and the SEC agreed, that Congress

offered no guidance whatsoever and that Congress has given the SEC exclusive authority and absolute discretion to decide whether to bring securities fraud enforcement actions with an ALJ or in an Article III court. Therefore, the delegation was unconstitutional.

Given the above, the Court held that because Congress gave the SEC a significant legislative power without guiding principles, the delegation of the legislative power was unconstitutional.

UNCONSTITUTIONAL STATUTORY REMOVAL RESTRICTIONS

Finally, the Court held that the statutory removal restrictions for SEC ALJs are unconstitutional given that SEC ALJs perform substantial executive functions and the President, therefore, must have sufficient control over the performance of their functions. The Court noted that two layers of for-cause protection impede the President's control over the SEC ALJs, which is forbidden under Supreme Court precedents.

Of primary importance was whether the SEC ALJs serve sufficiently important executive functions and whether the restrictions on their removal are sufficiently onerous that the President has lost the ability to take care that the laws are faithfully executed.

The Court noted that SEC ALJs may only be removed for cause by the SEC Commissioners and the Merits Systems Protection Board ("MSPB") and that SEC Commissioners and MSPB members can only be removed by the President for cause, which insulates SEC ALJs from the President by two layers of for-cause protection from removal.

For these reasons, the Court held that because SEC ALJs are sufficiently insulated from removal, the President lacks the authority to ensure that the laws are faithfully executed and, therefore, the statutory removal restrictions are unconstitutional.

Jarkesy v. SEC, No. 20-61007, 2022, available at:
https://www.ca5.uscourts.gov/opinions/pub/20/20-61007-CV0.pdf.

SEC Remarks

Chair Gensler Directs SEC Staff to Consider Recommendations for Market Structure Changes Affecting Retail Investors

In a recent speech, SEC Chair Gary Gensler addressed possible regulatory changes intended to address the "uneven playing field" resulting from the increasing role that private securities exchanges, or "dark pools," and wholesalers are playing in executing retail trades and potential changes to the national market system rules tailored to address concerns of competition and fairness.

Gensler identified six areas in which he has directed the SEC staff to examine and make recommendations on potential rule changes for the SEC Commissioners to consider.

Minimum Pricing Increment. Gensler asked the SEC staff to propose rules harmonizing the minimum pricing increments (*i.e.*, the "tick size") across market centers in an effort to address concerns of competition and fairness. Gensler noted that retail investors typically trade in exchanges based on prices in one-penny price increments, while wholesalers can fill orders in off-exchange venues using sub-penny prices. Specifically, he asked the SEC staff to make recommendations to ensure that trading occurs in the minimum tick size or to shrink the minimum tick size to better align with off-exchange trading.

National Best Bid and Offer (NBBO). In an effort to increase pre-trade transparency for retail investors, Gensler asked the SEC staff to consider changes to the calculation of the NBBO. The NBBO aggregates the highest and lowest bid ask prices for a security across exchanges to provide a bid-ask spread for investors before they trade. The current NBBO calculation rules only include round lots, or quotes for trades of 100 shares or more, and excludes quotes for all other "odd-lots," which also tend to be traded by retail investors. Gensler suggested that the SEC accelerate the implementation of the Market Infrastructure Rule, adopted by the SEC in 2020 and recently upheld in Court, which expands the definition of round lots and adds odd-lot information to core market data, and asked the SEC staff to consider whether there should be an NBBO quote for odd-lots.

Disclosure of Order Execution Quality. Gensler stated that enhanced disclosure would enable investors to better compare broker execution quality. Specifically, Gensler asked the SEC staff to consider subjecting broker-dealers to Rule 605 of Regulation NMS reporting requirements, which currently mandate "market centers" (*e.g.*, dark pools, wholesalers, and exchanges) to provide standardized reporting on order execution quality. Further, Gensler asked the SEC staff to make recommendations to require all Rule 605 reports to provide additional data on execution quality, such as the price improvement as a percentage of the spread.

Best Execution. Gensler raised the possibility that the SEC could implement its own requirements for broker-dealers to exercise reasonable diligence in executing orders. Gensler referenced both FINRA's and the MRSB's

already existing best execution rules but asked the SEC staff whether the SEC should consider its own best execution rules to provide more detail around the procedural standards brokers must meet when handling and executing customer orders.

Order-by-Order Competition. Gensler cited 2022 data that over 90% of retail marketable orders were routed to wholesalers that pay for the right to execute order flow. Gensler suggested that this practice leads to economic rents for wholesalers, and asked the SEC staff to examine whether a range of options, such as requiring stock auctions whereby trading firms compete on an order-by-order basis based on the best price, might better benefit retail investors.

Payment for Order Flow, Exchange Rebates, and Related Access Fees. Gensler noted that payment for order flow, exchange rebates, and related access fees can create conflicts of interest if they affect the prices and practices of brokers, thereby distorting their routing decisions. Gensler did not call for a ban on these practices, as some of them may benefit retail investors (*e.g.*, enabling brokers to provide commission-free trades), but he asked the SEC staff to identify how conflicts of interest could be mitigated. Gensler noted that increased disclosure about exchange fees and rebates and harmonizing minimum price increments could potentially allay these conflicts of interest.

Gary Gensler, SEC Chair, Speech, *"Market Structure and the Retail Investor:" Remarks Before the Piper Sandler Global Exchange Conference* (June 8, 2022), available at: https://www.sec.gov/news/speech/gensler-remarks-piper-sandler-global-exchange-conference-060822.

SEC Emphasizes the Critical Importance of the General Standard of Auditor Independence and an Ethical Culture for the Accounting Profession

On June 8, 2022, Paul Munter, Acting Chief Accountant for the SEC's Office of the Chief Accountant, released a statement emphasizing the SEC's focus on auditor independence and the critical role auditors play in gatekeeping and protecting investors.

The statement noted that Rule 2-01(b) of Regulation S-X, together with the four guiding principles included in the introductory paragraph of Rule 2-01, provides the framework for establishing the independence of accountants and auditors. In addition, Rule 2-01(c) of Regulation S-X contains a non-exclusive list of circumstances that are plainly inconsistent with the accepted standards of independence. Mr. Munter, however, cautioned that accountants, audit firms, registrants, and audit committees should not assume that a "mere checklist" compliance with Rule 2-01(c) concludes their independence analysis. In other words, compliance with the prohibitions enumerated in Rule 2-01(c) is necessary, but not alone sufficient in an independence analysis. Instead, accountants, audit firms, registrants, and audit committees should continue to assess auditor independence for

the purposes of considering, beginning or continuing an audit engagement. Moreover, he reminded firms that the SEC investigates and enforces against violations of the general standard, not Rule 2-01(c) compliance alone. In fact, in the past decade, the SEC staff has brought at least four enforcement actions for "standalone" violations of the general standard of auditor independence.

Mr. Munter then turned to address the OCA's approach to auditor independence consultations. He emphasized that the effectiveness of the consultation process requires that any party seeking guidance communicate all relevant facts and circumstances surrounding their inquiry. During auditor independence consultations, OCA staff will assess, among other things, (i) any prior consultations; (ii) risks presented to investors; and (iii) the impact of any rulemaking, judicial precedent or legislation subsequent to any prior consultations. However, he strongly cautioned firms against placing undue reliance on any historical OCA staff positions even in similar circumstances.

Mr. Munter further highlighted certain recurring issues in recent OCA staff auditor independence consultations. For instance, he noted that accounting firms should consider the implications for auditor independence when providing non-audit services, especially when the extent and magnitude of the non-audit services and business relationships between the accountant and affiliates and non-affiliates of the company being audited would make it difficult for a reasonable investor to conclude that the accountant could exercise objective and impartial judgment in its audit. Moreover, accounting firms should exercise caution when engaging in complex business arrangements and attempting to facilitate these arrangements through restructurings and the use of alternative practice structures.

In concluding his remarks, Mr. Munter reiterated that accounting firms should foster a culture of ethical behavior with respect to all aspects of their professional responsibilities, including auditor independence. Further, accounting firms should establish and maintain quality controls that adequately address regulatory requirements and monitor any internal efforts to circumvent such requirements.

Paul Munter, Acting Chief Accountant, Office of the Chief Accountant, Statement, *The Critical Importance of the General Standard of Auditor Independence and an Ethical Culture for the Accounting Profession* (June 8, 2022), available at: https://www.sec.gov/news/statement/munter-20220608.

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