Simpson Thacher

Registered Funds Regulatory Update

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SEC Rulemaking

SEC and FinCEN Jointly Propose CIP Requirements for RIAs and ERAs

The SEC and the Treasury's Financial Crimes Enforcement Network ("FinCEN") jointly proposed a rule that would require SEC-registered investment advisers and those that report to the SEC as exempt reporting advisers to establish and maintain written customer identification programs ("CIPs"). The proposal is designed to prevent illicit finance activities by strengthening the anti-money laundering and countering the financing of terrorism ("AML/CFT") framework for the investment adviser sector.

Under this proposal, investment advisers and exempt reporting advisers would be required, among other things, to implement reasonable procedures to identify and verify the identity of their customers in order to form a reasonable belief regarding their true identity. The proposed rule would make it more difficult for criminal actors to establish customer relationships, including by using false identities, with investment advisers for the purposes of laundering money, financing terrorism, or engaging in other illicit finance activities. The proposal is generally consistent with the CIP requirements for other financial institutions, such as broker-dealers. According to the proposal, the rule would apply to approximately 15,000 investment advisers and 5,550 exempt reporting advisers with $114 trillion in AUM and $5.2 trillion in gross assets, respectively.

This proposed rulemaking complements a separate FinCEN proposal made in February 2024 to designate investment advisers and exempt reporting advisers as "financial institutions" under the Bank Secrecy Act and subject them to, among other things, AML/CFT program requirements and suspicious activity report filing obligations. That proposal cited a risk assessment by the Treasury identifying the investment adviser industry as an access point into the U.S. market for illicit proceeds associated with criminal activities. Together, these proposals aim to prevent illicit finance activities in the investment adviser sector and further safeguard the U.S. financial system.

The proposed amendments are subject to comment until July 22, 2024. The proposed compliance date is 6 months from adoption.

Customer Identification Programs for Registered Investment Advisers and Exempt Reporting Advisers, Release No. BSA-1; RIN 3235-AN34 (May 21, 2024), available at: https://www.govinfo.gov/content/pkg/FR-2024-05-21/pdf/2024-10738.pdf.

SEC Adopts Significant Amendments to Regulation S-P Requiring Notification of Sensitive Customer Information Breaches, Service Provider Oversight

The SEC voted to make significant amendments to Regulation S-P, which governs the treatment of consumer non-public personal information collected by certain financial institutions: broker-dealers, investment companies, registered investment advisers and transfer agents registered with the SEC or another appropriate regulatory agency (collectively, "covered institutions"). It is estimated that compliance by large covered institutions will be required by early 2026, affording such covered institutions time to prepare with what may be onerous requirements.

At a high level, the amendments establish a federal "minimum" standard for covered institutions to provide data breach notifications to affected individuals. This federal standard applies regardless of, and is in addition to, any individual state's own requirements for data breaches. The federal standard expands the scope of customer information subject to Regulation S-P, requires a 30-day notification period for data breaches and establishes a new notification trigger that starts the 30-day notice period. The amendments further require each covered institution to adopt an incident response program for situations in which there is unauthorized access or use of customer information, specifically instituting a notification requirement to affected individuals if their "sensitive customer information" (e.g., social security numbers and other types of identifying information that can be used alone to authenticate an individual's identity, such as a driver's license, passport number, employer, or taxpayer ID) is, or is reasonably likely to have been, accessed or used without authorization. In addition, the amendments also implement recordkeeping requirements and provide an exception to the annual privacy notice delivery requirement (pending certain conditions) as well as requirements for oversight of service providers.

The SEC intended the amendments to consolidate standards for informing customers of sensitive information breaches, rather than rely on varying state requirements. While standardization of requirements can generally be helpful, the amendments impose operationally challenging notification requirements and deadlines. Covered institutions will likely need the entire compliance period to prepare operationally for those requirements.

Regulation S-P: Privacy of Consumer Financial Information and Safeguarding Customer Information, Release Nos. 34-100155; IA-6604; IC-35193 (May 16, 2024), available at: https://www.sec.gov/files/rules/final/2024/34-100155.pdf.

SEC Staff Guidance

SEC Issues Risk Alert on Marketing Rule

The Staff of the SEC's Division of Examinations published a new Risk Alert on the Marketing Rule, which had some important takeaways (framed as "preliminary observations"). The Alert is the Staff's most comprehensive written statement to-date on its observations on Marketing Rule compliance since the Marketing Rule was adopted (it has published two prior risk alerts on its Marketing Rule examination program). The Alert underscores that the Staff expects to continue its focus on Marketing Rule compliance in exams, which is evident from marketing being in the SEC's 2024 Exam priorities, the SEC's continued settlements of enforcement actions involving Marketing Rule violations and the recent SEC FAQ on fund performance and use of leverage.

The following are some key practical takeaways for firms from the Alert:

- Now that firms have been operating with the "new" Marketing Rule for some time, the Alert provides a reminder to firms to review policies and procedures, and assess whether they are being followed (or adjust as appropriate), and determine whether policies are tailored to the firm's business and actual advertising practices.
  - This includes policies and/or procedures addressing all channels the firm uses to advertise (e.g., social media, websites, podcasts) and ensuring review and record retention processes for content disseminated if using those platforms to "advertise."
  - Typically, Marketing Rule compliance is a function of a firm's compliance testing and monitoring, including testing that required records are being preserved.
    - While not a focus of the Alert, firms could also consider testing on other components of the Marketing Rule, including required oversight of placement agents.
  - Firms might consider refreshing training of relevant personnel, including in light of new developments and SEC guidance on the Marketing Rule's application.
    - Firms may want to consider how to make training specific and instructive, including providing firm personnel with examples or clear instructions on how to prepare materials that accord with the Marketing Rule and the firm's policies and procedures.
- Substantiation will remain a key focus and firms should retain required substantiation.
  - The Alert focuses on a few key areas, including: performance calculations, third-party ratings (e.g., copies of any questionnaires or surveys used in the preparation of such third-party rating) and support for other material statements of fact.

   - Consistent with market expectations, the Alert suggests that the Staff will view statements where firms cannot provide supporting records as "likely [to be] untrue" and therefore in violation of the general prohibition.
   - ESG (which is specifically mentioned) and other "hot button" SEC topics, such as AI, are likely to be key focus areas for substantiation.
- Firms also should continue to review marketing materials for perennial areas of SEC focus, including:
   - avoiding overstatement and puffery;
   - bringing forward information (one of the examples included in the Alert for substantiation was erroneous biographical information);
   - providing enough context in advertisements to avoid being seen as omitting material information (for example, around the basis of or criteria for awards or rankings), and especially in the context of presenting performance information; and
   - focusing on fair and balanced presentation of information, including performance information, and of risks.
- While firms with fiscal year-ends in December recently updated their Form ADVs, firms might consider tracking changes in their marketing practices as part of their regular compliance oversight to ensure they are capturing necessary updates for Form ADV (updates to information in Form ADV Part 1, Item 5, which contains the Marketing Rule questions, generally does not require an other-than-annual amendment, even if it becomes inaccurate).

Initial Observations Regarding Advisers Act Marketing Rule Compliance (Apr. 17, 2024), available at: https://www.sec.gov/files/exams-risk-alert-marketing-observation-2024.pdf.

Industry Developments

NYSE Proposes Rule Change to Exempt Registered CEFs From Annual Shareholder Meeting Requirements

The NYSE filed an Application with the SEC pursuant to Rule 19b-4 under the Exchange Act to amend Section 302.00 of the NYSE Listed Company Manual. Section 302.00 of the Manual requires CEFs listed on NYSE to hold an annual shareholder meeting every fiscal year. The proposed amendments would exempt NYSE-listed CEFs from the annual shareholder meeting requirement.

Although the Investment Company Act requires shareholder approval for various matters, it does not require CEFs to hold annual shareholder meetings. The Application states that NYSE believes that it is appropriate to exempt CEFs from the annual shareholder meeting requirements of Section 302.00 since the Investment Company Act provides "significant statutory protections" to CEF shareholders, which are not available to shareholders of public operating companies. The Application also notes that all other types of investment companies registered under the Investment Company Act and listed on NYSE are exempt from the annual shareholder meeting requirements, and NYSE believes the proposed changes are consistent with the protection of investors and the public interest.

The proposed rule change is subject to comment until July 30, 2024. The SEC will issue an order to approve or disapprove the proposed rule change, or institute proceedings to determine whether the proposed rule change should be disapproved within 45 days after such notice is published in the Federal Register, or within such longer period (up to 90 days, as the SEC may designate if it finds such longer period to be appropriate or as to which NYSE consents).

Self-Regulatory Organizations; New York Stock Exchange LLC; Notice of Filing of Proposed Rule Change Amending Section 302.00 of the NYSE Listed Company Manual To Exempt Closed-End Funds Registered Under the Investment Company Act of 1940 From the Requirement To Hold Annual Shareholder Meetings, Release No. 34-100460 (July 9, 2024), available at: https://www.govinfo.gov/content/pkg/FR-2024-07-09/pdf/2024-15037.pdf.

Key Takeaways for Fund Sponsors of Registered Funds Navigating ERISA's New Investment Advice Rule

The Department of Labor released a new Retirement Security Rule that re-defines the test for when one provides non-discretionary "investment advice" under ERISA. The Retirement Security Rule, which goes into effect on September 23, 2024, applies to sponsors of both registered and unregistered (i.e., private) funds. Key takeaways for sponsors of registered funds are set forth below.

Fund sponsors may communicate and interact with prospective and current investors that are "benefit plan investors," such as ERISA plans and IRAs ("ERISA Investors"), in a variety of ways. For example, registered fund sponsors usually engage directly with broker-dealers and other intermediaries and wholesalers, rather than with the underlying investors, who may include IRA owners and other retail retirement investors. Communications with intermediaries may involve sales pitches and providing information about the fund. These sponsors may have other touch points with the retirement community, including the fielding of investors' calls through a call center and promoting their funds to plan consultants and/or plan sponsors.

These communications and interactions were traditionally not treated as "investment advice" under ERISA because, under the historical rule, one was not considered an ERISA fiduciary that provided investment advice (an "Investment Advice Fiduciary") unless the advice was made, in part, on a "regular basis" and "pursuant to a mutual agreement" that the advice would "serve as a primary basis for investment decisions" and such advice was "individualized based on the particular needs" of the recipient of such advice.

The Retirement Security Rule presents a new paradigm for when one is deemed to provide non-discretionary investment advice to ERISA Investors. Importantly, the new rule provides that a *one-time* "recommendation" is sufficient to impute ERISA fiduciary status on the provider of such advice. Specifically, a person becomes an Investment Advice Fiduciary if such person provides a recommendation to the ERISA Investor (including a fiduciary representing the ERISA Investor that has control over the decision to invest in the fund) for a fee or other compensation with respect to a securities transaction, and such person either:

1. Directly or indirectly (e.g., through or together with any affiliate) makes professional investment recommendations to investors on a regular basis as part of their business *and* the recommendation is made under circumstances that would indicate to a reasonable investor in like circumstances that the recommendation is based on a review of the ERISA Investor's particular needs or individual circumstances, reflects the application of professional or expert judgment to the ERISA Investor's particular needs or individual circumstances, and may be relied upon by the ERISA Investor as intended to advance the ERISA Investor's best interest; or

2. Represents or acknowledges that they are acting as a fiduciary under Title I of ERISA, Section 4975 of the Internal Revenue Code of 1986, or both, with respect to the recommendation.

Key Takeaways for Registered Fund Sponsors

Communications with intermediaries and plan consultants present a relatively low risk that the fund sponsor will inadvertently provide investment advice under the Retirement Security Rule. This is because these entities are unlikely to be discretionary fiduciaries of the ERISA Investor, meaning, an inadvertent recommendation by the fund sponsor to such intermediaries and plan consultants should fall outside the scope of the new rule. A sponsor may, however, wish to disclaim fiduciary status in its communications with intermediaries for additional protection.

Communications with sponsors of ERISA Investors (i.e., plan sponsors) and retail ERISA Investors (i.e., IRAs) present a higher risk under the Retirement Security Rule. Meetings with plan sponsors, for example, may lead to "individualized" discussions regarding the fund and the plan's needs. Similarly, an IRA owner may call the sponsor's call center and ask if the fund is appropriate for their IRA. Sponsors may establish guardrails (i.e., scripts or policies on what can and cannot be said) for these types of communications so as to mitigate the risk of the fund sponsor being deemed to provide investment advice under the Retirement Security Rule. A sponsor may also disclaim fiduciary status in its communications with these investors for additional protection. It will be critical for sales and marketing communications—which are made to all investors—to be vetted in advance to ensure they do not suggest to the ERISA Investors that the sponsor is providing investment advice to them.

A sponsor's most significant risk of inadvertently providing investment advice under the Retirement Security Rule is likely where it offers separate accounts or funds-of-one for ERISA Investors. Prior to the ERISA Investors' commitment of capital, sponsors may wish to consider entering into a letter of understanding with the ERISA Investor to ensure the parties agree that the communications are viewed as being at arm's length and not fiduciary in nature.

A sponsor's current and future portfolio companies that provide financial services may also be impacted by the Retirement Security Rule. Sponsors should engage with the impacted portfolio companies to ensure steps are being taken to comply with the Retirement Security Rule. A fund sponsor's M&A diligence should also be augmented when the target provides financial services to ferret out potential non-compliance with the Retirement Security Rule on a going-forward basis.

The DOL amended several class exemptions (i.e., DOL Prohibited Transaction Class Exemptions 2020-02, 84-24, 75-1, 77-4, 80-83, 83-1 and 86-128) that relate to the provision of investment advice under ERISA. Because most fund sponsors should not be viewed as providing non-discretionary ERISA investment advice to ERISA Investors, for the aforementioned reasons, reliance on a prohibited transaction exemption is not necessary.

The Retirement Security Rule presents significant interpretive issues and challenges for certain other stakeholders—specifically, broker-dealers and those professionals selling certain insurance products and annuities may need to implement significant changes to their sales and marketing activities as a result of the new

Retirement Security Rule. It is anticipated that there will be numerous court challenges to the Retirement Security Rule.

Separate and apart from considerations presented under the Retirement Security Rule, ERISA fiduciary status can also arise where the fund sponsor exercises any authority or control over the management of an ERISA Investor's assets. If the sponsor operates its fund by satisfying an exception from holding "plan assets" (e.g., by reason of relying on the "registered investment company," "publicly-offered securities," "significant participation," "venture capital operating company," or "real estate operating company" exceptions), then the sponsor would not be acting as an ERISA fiduciary when managing the assets of that fund. However, if the sponsor manages the assets of an ERISA Investor's separate account, for example, it likely would be an ERISA fiduciary and the DOL's recent amendments to the QPAM Exemption may be germane.

Conclusion

The extent to which the Retirement Security Rule will impact a fund sponsor's day-to-day business will depend on a variety of factors, including whether such fund sponsor has direct communications with ERISA Investors. Fund sponsors should carefully consider the Retirement Security Rule in light of the discussion above; however, the ultimate impact of the new rule on normal fundraising activities may be minimal.

Retirement Security Rule: Definition of an Investment Advice Fiduciary, DOL RIN 1210–AC02 (Apr. 25, 2024), available at: https://www.govinfo.gov/content/pkg/FR-2024-04-25/pdf/2024-08065.pdf.

SEC Enforcement

SEC Settles With Global Provider of Business Communication and Marketing Services for Cybersecurity Control Failures

The SEC settled with a publicly traded company that is a global provider of business communication and marketing services for violations of the federal securities laws related to its inadequate response to a 2021 ransomware attack. The SEC's charges, rooted in failures of internal controls and disclosure procedures, underscore the SEC's intensified scrutiny of cybersecurity practices in public companies.

The company experienced a significant cybersecurity breach between November 2021 and January 2022. During this period, the company's internal systems issued multiple alerts about malware presence, but both the company's internal teams and its third-party managed security services provider failed to adequately address the threat. The SEC's investigation revealed that while the service provider initially reviewed and escalated some alerts, there was a critical lag in comprehensive response and remediation. Consequently, a threat actor installed encryption software and exfiltrated 70 gigabytes of sensitive data, impacting 29 of the company's 22,000 clients.

The SEC found that the company's cybersecurity incident controls and procedures were significantly flawed. According to the SEC, the company's reliance on the service provider without sufficient oversight, inadequate internal controls for reviewing and responding to cybersecurity alerts, and lack of effective communication channels contributed to the severity of the attack. The SEC's order emphasized that the company's failure to properly manage and audit the service provider's actions and resources led to the prolonged exposure and eventual data breach.

The SEC determined that the company violated two provisions of the Exchange Act. The company violated Section 13(b)(2)(B) of the Exchange Act, which mandates public companies maintain internal accounting controls that provide reasonable assurances regarding access to company assets. The SEC deemed the company's information technology systems and networks as assets, which necessitated robust internal controls to protect against unauthorized access. The SEC also found that the company violated Exchange Act Rule 13a-15(a), which requires public companies to maintain disclosure controls and procedures to ensure timely and accurate reporting of significant information. Thus, the company failed to design and implement effective controls for the timely communication of cybersecurity incidents to management, thereby impacting its disclosure decisions.

Without admitting or denying the SEC's findings, the company agreed to a cease-and-desist order and to pay a $2.125 million civil monetary penalty. In reaching the settlement, the SEC acknowledged the company's cooperation and remedial efforts. This included reporting the incident to the SEC before any public disclosure, revising cybersecurity policies and procedures, adopting new technologies, enhancing employee training, and increasing cybersecurity staff.

In the Matter of R.R. Donnelley & Sons Co., SEC Admin. Proc. File No. 3-21969 (June 18, 2024), available at: https://www.sec.gov/files/litigation/admin/2024/34-100365.pdf.

SEC Settles With Exchanges for Delayed Disclosure of Cyberattack

The SEC settled with Intercontinental Exchange, Inc. ("ICE") and nine of its subsidiaries, consisting of Archipelago Trading Services, Inc., New York Stock Exchange LLC, NYSE American LLC, NYSE Arca, Inc., ICE Clear Credit LLC, ICE Clear Europe Ltd., NYSE Chicago, Inc., NYSE National, Inc., and the Securities Industry Automation Corporation, for failing to immediately notify the SEC of a "cyber intrusion" as required by Regulation Systems Compliance and Integrity ("Regulation SCI").

According to the Order, a third-party informed ICE in April 2021 that ICE had been potentially impacted by a third-party malicious system intrusion in ICE's virtual private network. ICE investigated and immediately determined that a "threat actor" had inserted malicious code into a VPN device used to remotely access ICE's corporate network and reasonably concluded that its subsidiaries were also impacted by the intrusion. However, the Order found that ICE personnel did not notify legal and compliance personnel at ICE's subsidiaries about the intrusion for several days, violating ICE's own internal cyber incident reporting procedures. Due to ICE's failures, those subsidiaries were unable to properly assess the intrusion and fulfill their independent regulatory disclosure obligations under Regulation SCI, which required them to immediately contact SEC Staff and provide an update within 24 hours unless they immediately concluded or reasonably estimated that the intrusion had or would have no or a *de minimis* impact on their operations or on market participants. ICE and its subsidiaries internally logged the incident in its quarterly reporting to the SEC but did not notify or provide any information about the incident until the SEC independently contacted ICE about whether and how ICE and any of its subsidiaries had been impacted by the VPN vulnerability.

Without admitting or denying the findings, ICE and its subsidiaries agreed to a cease-and-desist order in addition to ICE agreeing to a $10 million civil monetary penalty.

In the Matter of Intercontinental Exchange Inc., et al., SEC Admin. Proc. File No. 3-21947 (May 22, 2024), available at: https://www.sec.gov/files/litigation/admin/2024/34-100206.pdf.

SEC Settles With Adviser for Impermissible Joint Legal Fee Arrangement

The SEC settled charges against a Puerto Rican-based registered investment adviser for entering into an impermissible joint arrangement with its client, an SEC-registered open-end investment company, resulting in the RIC temporarily paying a disproportionately high amount of legal costs.

According to the Order, the RIA improperly arranged for the RIC to pay, at least initially, the legal fees and expenses associated with regulatory inquiries and private litigation following significant losses of a series of the

RIC relating to an options trading strategy between December 2016 to February 2017. The Order stated that the RIA and RIC received SEC and other regulatory inquiries starting in February 2017 related to the RIC's losses, and were involved in an April 2017 class action and an August 2017 shareholder derivative action.

The RIA and RIC retained the same legal counsel to represent them in these matters, incurring legal expenses that amounted to $2.7 million. While the engagement letter acknowledged that conflicts of interest might arise between the RIA and the RIC, it failed to address how fees and expenses would be allocated between the RIA and RIC, including when legal services were rendered simultaneously to both entities. Moreover, the invoices did not delineate between the fees and expenses of the RIA versus the RIC.

The RIC maintained an insurance policy, subject to a deductible and a ceiling, to cover legal fees whereas the RIA did not. Because the regulatory inquiries and litigation involved overlapping facts and legal issues affecting both the RIA and the RIC, and to maximize coverage under the insurance policy, the RIA arranged for the RIC to pay all of the legal fees in connection with the regulatory inquiries and litigation, which were subsequently submitted under the RIC's insurance policy for repayment. According to the RIA, it planned to reimburse the RIC later for the fee amounts that the insurance provider determined were not properly allocable to the RIC and that would not be covered under the policy. Consistent with this, the RIA paid the RIC's portion of a private settlement and accounted for additional legal costs before the commencement of the SEC's investigation. However, neither the RIA nor the RIC disclosed the fee arrangement to the RIC's independent trustees. They also did not submit an application to the SEC seeking relief for the joint arrangement between the RIA and the RIC that would have otherwise been prohibited under the Investment Company Act. The Order found that the RIA benefitted from the impermissible joint arrangement by, among other things, deferring payment of its legal bills for multiple years.

Without admitting or denying the SEC's findings, the RIA consented to a cease-and-desist order, a censure, and agreed to pay disgorgement of $280,902, of which $183,757 was offset by a previous payment to the RIC, prejudgment interest of $30,081, and a civil monetary penalty of $200,000.

In the Matter of Catalyst Capital Advisors LLC, SEC Admin. File No. 3-21923 (Apr. 29, 2024), available at: https://www.sec.gov/files/litigation/admin/2024/ia-6597.pdf.

SEC Settles With Advisers for Marketing Rule Violations

The SEC settled charges against five registered investment advisers for Marketing Rule violations.

According to the Orders, the RIAs advertised hypothetical performance on their public websites without adopting and implementing policies and procedures reasonably designed to ensure that the hypothetical performance data "was relevant to the likely financial situation and investment objectives of each advertisement's intended audience," as required by the Marketing Rule.

The Order also found that one RIA violated other regulatory requirements under the Investment Company Act, including by making false and misleading statements in advertisements, advertising misleading model performance, failing to substantiate performance including in its advertisements, and failing to enter into written agreements for compensated endorsements in return for client referrals. The Order further found that the RIA committed recordkeeping and compliance violations and made misleading statements about its performance to a RIC client about the performance of a tracking account that it advised, which were included in the RIC's prospectus filed with the SEC.

Without admitting or denying the SEC's findings, each RIA consented to the entry of orders finding that it violated the Advisers Act and agreed to a censure, cease-and-desist order, and to comply with certain undertakings. One firm also agreed to a cease-and-desist order from future violations of the Investment Company Act and a civil monetary penalty of $100,000. The other four RIAs agreed to pay reduced civil monetary penalties ranging from $20,000 to $30,000, which reflected certain corrective steps taken by each of them prior to the SEC's involvement.

This is the second set of cases that the SEC has brought as part of its ongoing targeted sweep of Marketing Rule violations after having charged nine advisory firms in September 2023. Notably, for the first time, one of the current Orders included a violation of Section 34(b) of the Investment Company Act, which makes it unlawful for any person to make any untrue statement of a material fact, or omit to state a fact necessary to prevent any statements made from being materially misleading, in a registration statement or other document filed with the SEC. Previously, all other violations to date have been brought under the Advisers Act.

In the Matter of Gea Sphere, LLC, SEC Admin. File No. 3-21906 (Apr. 12, 2024), available at: https://www.sec.gov/files/litigation/admin/2024/ia-6585.pdf.

In the Matter of Insight Securities, Inc., SEC Admin. File No. 3-21909 (Apr. 12, 2024), available at: https://www.sec.gov/files/litigation/admin/2024/ia-6586.pdf.

In the Matter of Monex Asset Management, Inc., SEC Admin. File No. 3-21910 (Apr. 12, 2024), available at: https://www.sec.gov/files/litigation/admin/2024/ia-6587.pdf.

In the Matter of Credicorp Capital Advisors LLC, SEC Admin. File No. 3-21911 (Apr. 12, 2024), available at: https://www.sec.gov/files/litigation/admin/2024/ia-6588.pdf.

In the Matter of Bradesco Global Advisors Inc., SEC Admin. File No. 3-21912 (Apr. 12, 2024), available at: https://www.sec.gov/files/litigation/admin/2024/ia-6589.pdf.

SEC Settles With Adviser for Recordkeeping Failures

The SEC recently settled charges against a registered investment adviser for recordkeeping failures related to its employees' use of personal devices in connection with firm business.

According to the Order, from at least January 2019 through December 2021, the RIA's employees communicated about company business internally and externally through their personal text messages and other non-firm messaging platforms without maintaining or preserving the off-channel communications in violation of the federal securities laws and the RIA's policies and procedures. The Order stated that the failures involved employees at various levels of authority, including supervisors and senior employees. The Order noted that in one instance, three senior employees engaged in off-channel communications on personal devices that were set to automatically delete messages after 30 days. The Order stated that during this time, the RIA responded to SEC subpoenas for documents and records requests and the firm's recordkeeping failures would have likely impacted the SEC's investigations and ability to carry out regulatory functions.

The SEC found that the RIA violated certain recordkeeping provisions of the Advisers Act and failed to reasonably supervise with a view to preventing and detecting violations. Admitting to the SEC's findings and acknowledging that its conduct violated the federal securities laws, the RIA agreed to a cease-and-desist order, a censure, and an order to retain a compliance consultant to, among other things, conduct comprehensive reviews of the firm's policies and procedures. The RIA also agreed to a $6.5 million civil monetary penalty.

In the Matter of Senvest Management, LLC, SEC Admin. File No. 3-21900 (Apr. 3, 2024), available at: https://www.sec.gov/files/litigation/admin/2024/ia-6581.pdf.

Litigation

Supreme Court Issues Long-Awaited Regulatory Decisions

The Supreme Court issued notable decisions further curtailing the powers of federal administrative agencies. The expansion of the administrative state and the growth of regulatory bureaucracies over the latter half of the 20th century gave rise to legal doctrines under the Administrative Procedure Act ("APA") whereby courts came to rely on regulators both to interpret the bounds of their own statutory authority, and to adjudicate administrative cases enforcing their own regulations. The Court has significantly rolled back these trends, reasserting the independence of the courts in reviewing agency actions and reducing the scope of agencies' adjudicative authority.

In a pair of cases, the Supreme Court overruled the long-standing *Chevron* doctrine under which courts extended deference to agency interpretations in cases involving ambiguities in Congress' grant of regulatory authority. The Court thereby restored to federal district courts the ability to independently resolve ambiguities in disputes over agency action. In a second decision, the Court held that enforcing securities fraud claims in an in-house SEC tribunal violated defendants' Seventh Amendment right to a jury trial, removing administrative adjudicative authority over certain types of misconduct (like fraud) that were recognized at common law.

The Court Overturns *Chevron* Deference

For nearly 40 years, federal courts have employed the *Chevron* doctrine, named for the Supreme Court's 1984 decision in *Chevron v. Natural Resources Defense Council*, to extend deference to agency interpretations, including the SEC, in cases involving statutory questions of agency authority. Under *Chevron*, district courts were required to defer to an agency's interpretation of Congress' statutory delegation of regulatory authority, as long as the agency's interpretation was not unreasonable. The doctrine came to be challenged in a pair of cases before the Supreme Court where the District of Columbia Circuit and the First Circuit, respectively, upheld a regulation issued by a federal agency as a reasonable interpretation of a federal statute. On June 28, 2024, the Supreme Court overturned the lower courts' decisions and held in a 6-3 vote: "*Chevron* is overruled."

Writing for the majority, Chief Justice Roberts found that *Chevron* cannot be reconciled with the APA, which governs federal administrative agencies, and in fact "is the antithesis of the time honored approach the APA prescribes." While the APA requires courts to exercise their independent judgment in deciding whether an agency has acted within its statutory authority, *Chevron* asks the court "to *ignore*, not follow, 'the reading the court would have reached'" if no agency were involved.

The Court further criticized *Chevron* deference as "misguided" by presuming that agencies had special competence or necessary subject matter expertise in resolving statutory ambiguities. "The very point of the traditional tools of statutory construction," the Court observed, "is to resolve statutory ambiguities," and those are

the tools that courts—not agencies—use every day and should use particularly when the ambiguity concerns the scope of agency power.

Although the Court found that past judicial decisions have shown *Chevron* to be unworkable and unreliable as a result of inconsistent applications, it did not call into question prior cases that relied on the *Chevron* framework. Rather, the Court found that the holdings of those cases—including the Clean Air Act holding of *Chevron* itself—are still subject to statutory *stare decisis*, which is to say to stand by things decided, despite the Court's change in interpretive methodology.

While the impact of the Court's ruling remains to be seen, Justice Kagan warned in her dissent that it "is likely to produce large-scale disruption." The overturn of *Chevron*, Justice Kagan wrote, "is yet another example of the Court's resolve to roll back agency authority, despite congressional direction to the contrary."

In-House SEC Tribunals Violate Securities Fraud Defendants' Seventh Amendment Right

On June 27, 2024, the Supreme Court held that the SEC's adjudication of an enforcement action seeking civil penalties for alleged securities fraud in an in-house tribunal before an administrative law judge violated defendants' Seventh Amendment right to a jury trial. A 6-3 Justice majority affirmed the Fifth Circuit's judgment.

The SEC initiated an enforcement action against an investment fund founder and an investment adviser seeking civil penalties and other remedies, alleging that defendants had violated the antifraud provisions of the Securities Act, the Securities Exchange Act, and the Investment Advisers Act. Administrative adjudication of such claims has historically been utilized as a means to efficiently and expeditiously enforce regulations without the full scope of procedural rights and formalities attendant to litigation in federal court. The in-house proceedings resulted in a final order against defendants with a civil penalty of $300,000. Defendants petitioned for judicial review and a divided Fifth Circuit panel vacated the final order, holding that adjudicating the matter in-house violated defendants' Seventh Amendment right to a jury trial. After the Fifth Circuit denied a rehearing, the Supreme Court granted review.

Writing for the majority, Chief Justice Roberts affirmed the Fifth Circuit's decision as consistent with the Court's prior Seventh Amendment rulings. The Court concluded that this action implicates the Seventh Amendment because the antifraud provisions at issue "replicate common law fraud, and it is well established that common law claims must be heard by a jury," considering the Seventh Amendment's guarantee that in "suits at common law the right of trial by jury shall be preserved." Summing up, the Court stated that "the civil penalties in this case are designed to punish and deter, not to compensate. They are therefore a type of remedy at common law that could only be enforced in courts of law." The Court explained that its conclusion effectively decided that this suit implicated the Seventh Amendment and that a defendant would be entitled to a jury on these claims.

The Court also concluded that the "public rights" exception did not apply. This exception has been held to permit Congress to assign certain matters to agencies for adjudication. The Court found that this case did not fall within

any of the areas involving governmental prerogatives where the Court has concluded that a matter may be resolved without a jury. Emphasizing the importance of considering the substance of the action—not where it was brought, who brought it, or how it was labeled—the Court concluded that this action involved a matter of private rather than public right and that Congress may not withdraw it from judicial cognizance.

Although the SEC had already begun to restructure its enforcement docket in the years prior to the ruling in June 2024, moving most categories of cases away from administrative courts, the Court's decision will materially accelerate the trend of litigating disputed SEC cases (whether alleging fraud or otherwise) in federal court. Beyond those immediate ramifications, the ruling may have sweeping implications not only for the SEC, but for other federal agencies that have made use of administrative tribunals in a similar fashion—the Commodity Futures Trading Commission, the Federal Trade Commission, and the Federal Communications Commission among them. Because such cases can no longer be brought in the relatively efficient forum of an in-house tribunal, agencies like these may face difficult choices in allocating finite enforcement resources, given the resources necessary to litigate each of them fully in federal court.

Loper Bright Enterprises v. Raimondo, No. 22-1219, 2024 WL 3208360 (U.S. June 28, 2024)

Relentless, Inc. v. Dep't of Com., No. 22-1219 (U.S. argued Jan. 17, 2024).

SEC v. Jarkesy et al., No. 22-859 (U.S. June 27, 2024).

Fifth Circuit Vacates the SEC's Private Fund Adviser Rules

A panel of three judges on the Fifth Circuit Court of Appeals issued its opinion in a 3-0 decision to vacate the entirety of the SEC's Private Fund Adviser Rules on the grounds that the SEC lacked statutory authority to adopt the Rules. The Fifth Circuit's decision amounts to a complete victory for the various trade associations that challenged the legality of the Rules. It is not yet clear whether the SEC will request further rehearing by the Fifth Circuit or appeal the decision to the Supreme Court, and the SEC has a mixed record on appealing decisions vacating its prior rulemakings.

The trade associations had claimed four potential grounds for the Fifth Circuit to possibly vacate the Rules: (i) the SEC exceeded its statutory authority; (ii) the final Rules were not a logical outgrowth of the SEC's proposed rulemaking; (iii) the final Rules adopted were arbitrary and capricious; and (iv) the SEC failed to adequately consider the Rules' impact in adopting them (i.e., the SEC failed to conduct an adequate economic analysis). Generally, federal courts must uphold SEC rulemaking unless the rulemaking exceeded the SEC's statutory authority or was arbitrary, capricious, an abuse of discretion or otherwise unlawful, and the courts must generally defer to SEC factual assertions as conclusive.

The opinion rejected the SEC's argument that it has the ability to regulate private funds under Section 211(h) of the Advisers Act (which was promulgated under the Dodd–Frank Act) and the opinion also vacated those portions of the Rules promulgated under Section 206(4) (which the SEC has regularly used for other Advisers Act rulemakings, including the SEC's marketing rule and compliance program rule) as lacking a sufficient nexus to identified fraud.

In particular, the Court found unpersuasive the SEC's arguments that provisions of Section 211(h), which in certain cases refer to "investors," were intended to regulate interactions between private fund advisers and their limited partners and affirmed that Congress, in adopting Dodd-Frank, intended to preserve the different regulatory treatment of private fund advisers and their relationships with their client funds. Heeding the arguments of petitioners, the Court affirmed the circumscribed scope of Advisers Act regulation (in contrast to the more prescriptive approach to regulating funds under the Investment Company Act), in particular citing the sophistication of private fund investors.

As noted above, the Court also rejected the SEC's arguments that the entire rulemaking was supported by Section 206(4) authority, finding that the SEC's "anti-fraud" rationale for adopting the Rules was "pre-textual" and that the SEC did not articulate "a rational connection" between fraud (which the SEC can adopt rules designed to prevent under Section 206(4)) and the final adopted Rules. Agreeing with petitioners, the Fifth Circuit said the SEC failed to explain how the Rules would prevent fraud and that Section 206(4) requires the SEC to also "define" a practice as fraudulent in order to prevent it, finding that the SEC's "vague assertions" fell short of this requisite definitional specificity. (In particular, the Court noted that the SEC has observed misconduct by only 0.05% of advisers, most of which were settled actions.) The Court also challenged the SEC's ability to adopt the "disclosure and reporting" requirements of the Rules under Section 206(4) authority. In all, the Court found that the Rules were insufficiently "reasonably designed" to prevent fraud or deception against an adviser's clients (i.e., their funds) under Section 206(4). In issuing its decision, the Court reasoned that "[b]y Congressional design, private funds are exempt from federal regulation of their internal 'governance structure'" (unlike funds regulated under the Investment Company Act), and that the SEC cannot "promulgate rules under the guise of Section 206(4) that [affect] this internal governance structure."

Because the Rules were vacated on statutory authority grounds, other arguments made by the petitioners were not considered (and the Court also dismissed the SEC's invalid standing and improper forum arguments).

The SEC has not yet reacted publicly to the decision and it remains to be seen what action they will take in response, including whether to seek further review. Although the Rules have been vacated by the Court's ruling, the SEC could theoretically seek a stay of the decision pending further appeal, which would allow the Rules to take effect on their respective compliance dates pending the outcome of the appeal. It is not clear that the SEC would be successful in pursuing such a stay or that the SEC would even request one.

While the Court's decision with respect to the SEC's Section 211(h) authority may not be all that surprising to those that have been watching the case, the Court's skeptical view of the SEC's arguments under Section 206(4)

coupled with the SEC's historical reliance on Section 206(4) and its ambitious rulemaking agenda—which in numerous instances relies on that authority—may give the SEC extra incentive to consider appealing this decision further. Alternatively, the SEC might attempt to rely on the Court's specific finding regarding a lack of a "close nexus" in this particular case to determine that the SEC's authority under Section 206(4) has not been limited in a way that would materially curtail future rulemakings or call into question prior or currently pending rulemakings.

Regardless of whether the SEC chooses to further pursue saving the Rules in the Courts, the SEC may use its examination and enforcement powers under the existing Advisers Act framework to pursue some of the concerns (and alleged abuses) it sought to address in the Rules and which it detailed at length in the proposing and adopting releases for the Rules.

N.A. of Private Fund Managers, et al. v. SEC, No. 23-60471 (June 5, 2024), available at: https://www.ca5.uscourts.gov/opinions/pub/23/23-60471CV0.pdf.

SEC Remarks

Division of Enforcement Deputy Director Lays Out Factors for Assessing Recent SEC Penalties

In a recent speech at the SEC Speaks 2024 conference, SEC Division of Enforcement Deputy Director Sanjay Wadhwa discussed the various factors the SEC is using to assess recent penalties for both off-channel communication and related recordkeeping violations and violations of the newly amended Marketing Rule.

Wadhwa stated that the following six key factors are being used by the Division to assess penalties in connection with its ongoing focus on off-channel communication and related recordkeeping violations: (i) the size of the firm, both in terms of revenue and number of SEC registrants employed; (ii) scope of violations; (iii) the firm's efforts to comply with recordkeeping obligations; (iv) precedent; (v) self-reporting; and (vi) cooperation. He reported that the SEC issued 41 settlement orders against 60 firms for off-channel communication violations resulting in combined penalties of over $1.7 billion since December 2021. These penalties ranged from $2.5 million to $125 million.

Despite the wide-range in penalties, Wadhwa confirmed that each penalty is based on an individualized assessment of each firm. According to Wadhwa, this assessment includes consideration of the size of the firm in determining whether a penalty would act as a deterrent against future violations. In determining the breadth and depth of violations, he noted that the SEC considers the number of employees that engaged in off-channel communications as well as the number of violations. He noted that firms that have adopted technology or other solutions to comply with recordkeeping obligations may face reduced penalty amounts. He confirmed that precedent is used as a guide but is not a determinative factor. Finally, he said that the most likely factor to significantly lower the recommended penalty is whether the firm self-reported but that the SEC will also take into account the firm's cooperation in the investigation.

With regards to Marketing Rule violations, Wadhwa reported that the SEC's initiative to enforce compliance has resulted in penalties ranging from $175,000 to $50,00. He noted that the SEC is using the following five factors to assess penalties: (i) the firm's regulatory assets under management; (ii) the firm's regulatory history; (iii) whether the firm took remedial actions; (iv) the SEC's intent to deter future activity; and (v) self-reporting and cooperation.

Wadhwa concluded by stating that the factors identified are generally relevant to any SEC investigation.

Sanjay Wadhwa, SEC Division of Enforcement Deputy Director, Speech, *Remarks at SEC Speaks 2024* (Apr. 3, 2024), available at: https://www.sec.gov/news/speech/sanjay-wadhwa-sec-speaks-2024-04032024.

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