Simpson Thacher

Registered Funds Regulatory Update

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SEC Enforcement

CCO Found Personally Liable for Compliance Failures

In a June 2020 administrative proceeding, the SEC held Jeffrey Kirkpatrick, the Chief Compliance Officer and a Principal of Hamilton Investment Counsel, LLC ("HIC"), a registered investment adviser, personally liable for failing to implement certain compliance policies and procedures for outside business activities. According to the Order, Kirkpatrick failed to implement the adviser's compliance program by inadequately responding to multiple red flags surrounding an investment advisory representative's ("IAR") outside business activities.

HIC's compliance program specifically required that its IARs disclose outside business activities to the adviser. Beginning at least in February 2020, Kirkpatrick became aware that an IAR was conducting outside business activities but, contrary to the adviser's compliance program, he did not require the IAR to complete and submit a formal report, conduct a sufficient review to determine whether the outside business activity raised any conflicts of interest or take sufficient steps to verify that HIC or the IAR had appropriately disclosed to clients the IAR's outside business activities and any resulting conflicts. Over the next several months, Kirkpatrick was notified several additional times of the IAR's outside business activities that indicated that he was in violation of the compliance program. Then in August 2020, Kirpatrick failed to review the legitimacy of certain transactions flagged by the broker-dealer with which the IAR was also associated involving the transfers of client assets to the IAR's other business. Thereafter, in November 2020, Kirkpatrick learned that the IAR had been using HIC's office address for an outside business but did not take steps to ensure that the outside business activity was adequately and accurately reported.

According to the SEC, Kirkpatrick had multiple opportunities to cure the compliance failures because the wrongful activity came to his attention in various forms multiple times over a substantial period. Furthermore, the conduct at issue was not merely a technical violation of the compliance program but rather a fundamental failure to effectively implement the adviser's compliance program to protect clients.

Without admitting or denying the SEC's findings, HIC and Kirkpatrick agreed to a cease-and-desist order, and civil monetary penalties in the amount of $150,000 and $15,000, respectively. In addition, Kirkpatrick received a five-year bar from acting in a supervisory or compliance capacity with, among others, a broker-dealer or investment advisory firm.

In the Matter of Hamilton Investment Counsel, LLC and Jeffrey Kirkpatrick, SEC Admin. Proc. File No. 3-20920 (June 30, 2022), available at: https://www.sec.gov/litigation/admin/2022/34-95189.pdf.

Chief Compliance Officer Liability: Statement on In the Matter of Hamilton Investment Counsel LLC and Jeffrey Kirkpatrick, Commissioner Hester Peirce (July 1, 2022), available at: https://www.sec.gov/news/statement/peirce-statement-hamilton-investment-counsel-070122.

Adviser Charged With Violations of Proxy Voting Rules

On September 20, 2022, the SEC settled charges against Toews Company, a registered investment adviser, for failing to determine if proxy votes were cast in its clients' best interests and implement appropriate proxy voting policies and procedures.

From January 2017 to January 2022, Toews engaged a third-party proxy advisory firm to vote proxies on behalf of its mutual fund clients. At over 200 shareholder meetings, Toews directed the proxy advisory firm to vote against shareholder proposals and in favor of management proposals without determining whether it was in their clients' best interests. According to the Order, in doing so, Toews violated Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-6 thereunder, which prevent advisers from exercising voting authority on behalf of clients unless the adviser has implemented written policies and procedures that are reasonably designed to make determinations with regard to clients' best interests. Noting that Toews maintained its standing instruction without deviation over a five-year period, the Order found that Toews failed to make such determinations.

Without admitting or denying the findings, Toews agreed to a cease-and-desist order, censure and civil monetary penalty of $150,000.

In the Matter of Toews Corporation, SEC Admin. Proc. File No.3-21113 (September 20, 2022), available at: https://www.sec.gov/litigation/admin/2022/ia-6139.pdf.

Private Equity Fund Adviser Fined Over Fee Repayment Issues

On September 23, 2022, the SEC settled charges against Wave Equity Partners LLC, a registered investment adviser, for failing to promptly repay management fees owed to Wave Equity Fund II, a private equity fund. The SEC action is one of a number of enforcement actions brought this year against private fund advisers for fee, expense and valuation violations.

From May 2018 through October 2020, Wave Equity borrowed nearly $1.1 million from the Fund to pay placement agent fees to a third-party vendor. The Fund's partnership agreement and private placement memorandum required prompt repayment of the borrowed funds through an offset of the quarterly management fees paid to Wave Equity. According to the Order, Wave Equity did not repay the loan or reduce its management fees charged to investors for 11 consecutive quarters. Instead, the Fund used the management fees it collected to

pay its own operating expenses. Moreover, for nearly a two-year period, the Fund did not disclose the loan to investors and potential investors and was thereby in violation of its governing documents.

Without admitting or denying the SEC's findings, Wave Equity agreed to pay a $325,000 civil monetary penalty. In reaching a settlement, the SEC took into consideration Wave Equity's remedial efforts, which included fully paying back the Fund with interest and hiring a new chief compliance officer and outside compliance consultant.

In the Matter of Wave Equity Partners LLC, SEC Admin. Proc. File No. 3-21144 (September 23, 2022), available at: https://www.sec.gov/litigation/admin/2022/ia-6146.pdf.

SEC Settles With Advisers for Conflict of Interest Claims

The SEC recently settled charges against Private Advisor Group ("PAG") and Mesirow Financial Investment Management ("Mesirow"), each a registered investment adviser, for failing to disclose conflicts of interest that arose from the advisers' recommendations of certain mutual fund share classes. Mesirow and PAG join dozens of other firms that have settled share class and similar conflicts of interest claims with the SEC in recent years.

Private Advisors Group

An Order found that, since at least July 2014, PAG allegedly invested certain client assets in higher-cost mutual fund share classes when lower cost options were available and failed to disclose the conflicts of interest related to those investments. According to the Order, PAG was responsible for paying transaction fees on mutual fund investments in client wrap accounts. Those transaction fees were deducted directly from investment adviser representatives' compensation. The SEC alleged that PAG avoided incurring these transaction fees by investing certain client assets in a no transaction fee ("NTF") program through its clearing firm. Certain mutual funds were made available to clients through both the NTF and wrap fee programs, and PAG recommended its clients invest in the NTF share classes, which often had 12b-1 fees, instead of the wrap fee program share classes of the same mutual fund, which did not have 12b-1 fees, to avoid paying the transaction fees on client trades within these mutual funds.

The Order found that PAG violated the anti-fraud provisions of the Advisers Act for failing to disclose conflicts of interest and breached its duty of care, including its duty to seek best execution, by failing to undertake an analysis to determine whether particular mutual fund share classes it selected were in its clients' best interests.

Without admitting or denying the findings, PAG agreed to a cease-and-desist order, a censure and a civil monetary penalty of $5,800,000.

Mesirow Financial Investment Management

An Order found that, from at least February 2015 through May 2019, Mesirow breached its fiduciary duty to its advisory clients by recommending investments in mutual funds and share classes that paid revenue sharing to its affiliated broker-dealer, Mesirow Financial, Inc. ("MFI"), without disclosing the conflict of interest. Some of these mutual funds that paid revenue sharing were more expensive than lower cost options available to clients, including lower cost share classes of the same mutual funds that did not participate in revenue sharing. According to the Order, Mesirow also breached its duty to seek best execution by causing these advisory clients to invest in more expensive share classes of mutual funds when share classes of the same funds were available to clients that presented a more favorable value.

Without admitting or denying the findings, Mesirow agreed to a cease-and-desist order, a censure, disgorge profits of $487,862 plus interest and a civil monetary penalty of $170,000.

In the Matter of Private Advisor Group, LLC, SEC Admin. Proc. File No. 3-20933 (July 21, 2022), available at: https://www.sec.gov/litigation/admin/2022/ia-6069.pdf.

In the Matter of Mesirow Financial Investment Management, Inc., SEC Admin. Proc. File No. 3-20934 (July 22, 2022), available at: https://www.sec.gov/litigation/admin/2022/34-95351.pdf.

Litigation

Supreme Court Extends "Major Questions Doctrine" to Regulatory Rulemaking

The U.S. Supreme Court recently vacated a decision by the D.C. Circuit allowing the Environmental Protection Agency (the "EPA") to regulate greenhouse gas emissions, holding that the EPA exceeded its congressional authority in adopting rules under the Clean Air Act. This holding extends beyond environmental regulation and has the potential to significantly impact current and future rulemaking for federal agencies. Until this decision, federal agencies, including the SEC, have had wide discretion to interpret ambiguities in statutes they have been charged to enforce pursuant to a legal standard known as "Chevron deference" unless such interpretations are deemed unreasonable. The Supreme Court's decision establishes a new legal standard known as the "major questions doctrine," which will require federal agencies to have "clear congressional authorization" to adopt rules on issues of "economic and political significance." The major questions doctrine has previously been cited by lower courts but this marks its debut in a Supreme Court decision. Notably, the Supreme Court did not define what constitutes a major question with respect to an agency's authority, leaving many in the industry questioning the validity of the SEC's recent proposal to standardize public company disclosure of their climate-related risks and greenhouse gas emissions.

The SEC's proposed rule, published on March 21, 2022, has been specifically cited as a target for potential litigation under the major questions doctrine. Critics of the proposed rule have asserted that it would be wise for the SEC to retract and rethink the proposed rule arguing that it raises a major question under the new doctrine as to whether the SEC has exceeded its regulatory authority beyond the scope of its expertise. At the very least, critics have urged the SEC to reopen the proposal's comment period. Although the extent to which regulatory actions will be challenged using this new doctrine is unknown, the Supreme Court did note that the doctrine is only to be applied in "extraordinary cases."

West Virginia v. Environmental Protection Agency, No. 20–1530, 2022, available at: https://www.supremecourt.gov/opinions/21pdf/20-1530_n758.pdf.

ICI Backs Nuveen in Closed-End Funds Appeal

In June 2022, the Investment Company Institute filed an Amicus brief (a so-called "friend of the court" brief) in a case involving Saba Capital. The brief argues that the U.S. Court of Appeals for the Second Circuit should reverse the decision of the lower District Court and hold that the board of directors of certain Nuveen closed-end funds did not violate Section 18(i) of 1940 Act when it adopted bylaw provisions restricting the ability of shareholders, including appellee Saba Capital, to freely vote more than 10% of its shares of the fund's voting power.

The ICI argued that the lower court misapplied Section 18(i), which states that "[e]xcept . . . as otherwise required by law, every share of [fund] stock . . . shall be a voting stock and have equal voting rights with every other outstanding voting stock." Specifically, the ICI stated that the District Court's holding is inconsistent with the text and purpose of the 1940 Act and would empower activist shareholders to harm other shareholders.

The ICI highlighted that the purpose of the 1940 Act is to protect all shareholders even against concentrated shareholders that would likely constitute "affiliated persons" holding 5 percent or more of the outstanding voting securities of the fund. Such affiliated persons, the ICI noted, could pursue objectives to their benefit and the detriment of all other shareholders. This "self-interested" behavior was precisely the behavior Congress anticipated in adopting the 1940 Act. In fact, the ICI argued that the 1940 Act permits a board of directors to protect shareholders by adopting provisions, such as anti-takeover provisions, that limit concentrated shareholders from voting in a manner counter to the interests of all other shareholders.

Finally, the ICI noted that the District Court's decision, if upheld, could empower activist shareholders to cause harm to closed-end funds and their shareholders. Specifically, the ICI referenced historical behavior of activists that could have detrimental effects on other shareholders, including activists seeking short-term profits at the expense of long-term investors, liquidating closed-end funds, forcing tender offers that effectively increase fund expense ratios, and converting closed-end funds to open-end funds.

Brief of Investment Company Institute as Amicus Curiae Supporting Appellants, Saba Capital CEF Opportunities 1, Ltd, et al. v. Nuveen Floating Rate Income Fund, et al., 2022 WL 2268209 (June 17, 2022).

Federal Court Imposes Hefty Penalties on Adviser in Share Class Selection Case

On September 7, 2022, the U.S. District Court for the Eastern District of Pennsylvania entered final judgments against Ambassador Advisers, LLC, a registered investment adviser, and three of its executive officers (the "Individual Defendants" and, collectively with Ambassador, "Defendants") for violating the anti-fraud provisions of the Advisers Act. The final judgments are part of a long-running SEC enforcement action in connection with a scheme whereby Ambassador recommended that its clients purchase mutual fund share classes with 12b-1 fees over other share classes that did not charge such fees.

The Ambassador enforcement action is one of several SEC actions focusing on conflicts of interest stemming from mutual fund share class selection practices by advisers. However, the Ambassador case is distinctive because the adviser rejected a settlement with the SEC and proceeded to trial instead.

From 2014 to 2018, Defendants invested its clients in mutual fund share classes that charged 12b-1 fees, even when the clients were eligible to invest in share classes of the same fund without 12b-1 fees. Ambassador then collected the 12b-1 fees and distributed the fees to Ambassador's brokers and one of the brokers kicked back more

than $1 million of 12b-1 fees to the Individual Defendants. The Court focused on the Defendants' fiduciary duties and best execution responsibilities and the conflicts of interest that arose from the Defendants' share class selection practices. The Court noted that the Defendants' compliance consultant informed them of the potential conflicts of interest and provided a model compliance policy that would seek to address those conflicts, which the Defendants ignored.

At trial in March 2022, the jury returned a verdict against the Defendants. Following the trial, Ambassador released a video and a statement acknowledging the outcome but deflecting blame on the SEC, claiming that it had followed SEC disclosure requirements and "clients were never overcharged, nor were gains or returns compromised in any way."

After the jury trial, the SEC sought (i) a permanent injunction from future violations of the securities laws; (ii) civil monetary penalties of over $2 million, consisting of $622,642 in disgorgement, $166,520 of prejudgment interest and $1,244,188 in civil penalties; and (iii) the removal of misleading information about the case from Ambassador's website and Form ADV, along with a written corrective notice to affected clients.

The Court declined to grant an injunction but granted the requested civil monetary penalties. The Court also ordered Defendants to update its website and Form ADV disclosures and send a corrective notice to affected clients.

SEC v. Ambassador Advisors, LLC, No. 5:20-cv-02274-JM, 2022; available at: https://www.govinfo.gov/content/pkg/USCOURTS-paed-5_20-cv-02274/pdf/USCOURTS-paed-5_20-cv-02274-4.pdf.

SEC Remarks

SEC Enforcement Director's House Testimony Signals the Division's Priorities

On July 21, 2022, Gurbir Grewal, Director of the SEC's Division of Enforcement, provided testimony signaling the Division's upcoming priorities before the House Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets.

Grewal began by reporting that in fiscal year 2021, the SEC filed 434 enforcement actions, a seven percent increase over the previous year and the SEC's whistleblower program had a record-breaking year with 108 whistleblowers earning $564 million during the fiscal year, compared to 39 whistleblowers in the previous year. During fiscal year 2021, the Division also had approximately 1,500 open investigations, approximately 2,000 pending civil litigations and approximately 1,200 pending administrative proceedings. Grewal testified that his aim is to restore the public's trust in the financial markets through robust enforcement, robust remedies and robust compliance.

Robust Enforcement

Grewal testified that the Division is taking proactive steps to police new areas of importance for investors, as well as the "continually evolving risks," including in crypto assets and cybersecurity, noting that the SEC brought a number of notable new enforcement actions over the past year and announced the addition of 20 new positions to its Crypto Assets and Cyber Unit. The expanded Unit will be responsible for investigating crypto asset offerings, exchanges, broker-dealers and lending and staking products; decentralized finance platforms; non-fungible tokens (NFTs); and stablecoins. He also discussed the focus on gatekeeper accountability, citing recent charges against Ernst & Young LLP alleging that a significant number of its audit professionals cheated on exams required for their accounting licenses.

Robust Remedies

Grewal testified that the Division seeks to impose remedies that deter wrongdoers from violating the securities laws rather than just punishing them. Grewal explained that in making penalty recommendations, the Division assesses whether prior penalties in comparable cases were sufficient to appropriately deter the wrongful activity and where it was not, it will seek heightened penalties both in settlement negotiations and, if necessary, in litigation. The Division will also seek heightened penalties for recidivists where the prior penalties did not have the intended deterrent effect. According to Grewal, prophylactic relief (*e.g.*, officer and director bars) is also an important remedy for the Division because it is designed to prevent a wrongdoer from engaging in future misconduct and serves as a core gatekeeper role in the securities markets. Grewal then confirmed that the

Division will continue to primarily seek no-admit-no-deny settlements but will seek admissions of wrongdoing to provide greater clarity of the particular facts of the violations or send a strong message to the industry.

Robust Compliance

Grewal testified that firms should not rely on "check-the-box" compliance policies but instead should develop bespoke policies and procedures specifically tailored to their individual businesses and the associated risks. Moreover, firms need to ensure that they appropriately address "red flags" and disclosure is accurate and timely.

Gurbir S. Grewal, SEC Division of Enforcement Director, "*Testimony on "Oversight of the SEC's Division of Enforcement" Before the United States House of Representatives Committee on Financial Services Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets*" (July 21, 2022), available at: https://www.sec.gov/news/statement/grewal-statement-house-testimony-071922.

IM Director's Conference Remarks on Division Priorities

On July 26, 2022, William Birdthistle, Director of the SEC's Division of Investment Management, addressed areas of particular interest to the Division, specific developments confronting the investment management industry and a topic of recurring interest, money market funds.

Areas of Interest for the Division

Birdthistle began his remarks by addressing three areas where the Division could improve its oversight of funds and advisers. The first area he noted was a focus on fees, specifically complex fee arrangements, such as those that include revenue sharing and soft dollars. He added that the Division's focus on fees may take many forms, including the form and content of disclosure and ensuring that advisers comply with their fiduciary duties. The second area of opportunity is through the proposed rules on private fund advisers, which Birdthistle noted would shine a light on a "darkened corner of our markets." The proposed rules would require private fund advisers to provide investors with quarterly statements, require private fund advisers to obtain annual audits, address the possibility for conflicts resulting from adviser-led secondary transactions, and prohibit certain practices by private fund advisers that are contrary to public interest. The third area of opportunity is the democratization of proxy voting, which Birdthistle noted is delegated to large asset managers and does not fairly reflect the views and priorities of American investors.

LIBOR and MiFID II

Birdthistle then turned to discussing two specific changes in the investment management industry: the cessation of LIBOR and the impact of MiFID II on the market for investment research.

With regards to LIBOR, Birdthistle noted that substantial progress had been made in preparing for the transition away from LIBOR on June 30, 2023. As part of the preparations for the transition, he reminded asset managers

that they should understand their exposure to LIBOR-linked issuers, such as identifying data sources for security-specific updates from designated parties on fallback rates and conventions, and appropriately plan for how and when portfolio positions will convert from their use of LIBOR to an alternative reference rate. Additionally, Birdthistle stated that asset managers should be cognizant of how the value and liquidity of LIBOR-linked investments may change and ensure that all material risks are disclosed to investors.

Birdthistle then addressed MiFID II and its impact on the U.S.-EU investment research market. He noted that in response to the passing of MiFID II in Europe, which, among other things, prevents asset managers in Europe from purchasing broker-dealer research with "soft dollars," the SEC staff issued three no-action letters, including a no-action letter taking the position that the Staff would not consider a broker-dealer that accepted compensation through certain arrangements required by MiFID II to be an investment adviser during a temporary period specified in that letter. He added that the Division does not intend to extend this temporary position beyond its current expiration date in July 2023 and does not expect to issue further assurances with respect to the adviser status of broker-dealers accepting compensation under MiFID II arrangements. Further, he stated that to the extent that the no-action letters include statements or positions that are independent of the temporary adviser status position, such as those regarding client commission arrangements, they are not being rescinded.

Money Market Fund Reform

Birdthistle ended his remarks with a discussion of money market fund reform, including provisions of the proposed rule announced in December 2021. He discussed the market stresses in March 2020, which led to record flows for money market funds. He then discussed the merits of swing pricing, a key component of the rule proposal, noting that it would be a creative solution in a future liquidity crisis.

William Birdthistle, SEC Director of Division of Investment Management, Speech, *Remarks at PLI: Investment Management 2022* (July 26, 2022), available at: https://www.sec.gov/news/speech/birdthistle-remarks-pli-investment-management-2022-072622.

Legislative Developments

Senate Bill Seeks Expanded SEC Registration of Private Companies

In September, a bill was introduced in the Senate that would require certain large privately held companies to register with the SEC. Specifically, the bill would require a private company to register with the SEC within 18 months after the end of the first fiscal year when (a) the company's valuation exceeds $700 million (excluding the value of shares held by affiliates of the company), or (b) the company's revenues exceed $5 billion and it has at least 5,000 employees. The bill would also require such an issuer to submit an annual certification of the value of its shares held by affiliates. Notably, the bill authorizes the SEC to exempt certain investment companies from the registration requirements.

Private Markets Transparency and Accountability Act, S. 4857, 117th Cong. (2022), available at: https://www.congress.gov/117/bills/s4857/BILLS-117s4857is.pdf.

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