GODFREY & KAHN

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Investment Management Legal and Regulatory Update

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LATEST DEVELOPMENTS: FUNDS

SEC Charges Adviser and Trustees with Liquidity Rule Violations

On May 5, 2023, the SEC filed its first enforcement action with respect to Rule 22e-4 (the Liquidity Rule) under the Investment Company Act. The complaint was brought against a mutual fund's adviser, Pinnacle Advisors, LLC (Pinnacle), the fund's president (who was also a portfolio manager), the fund's chief compliance officer and the fund's two independent trustees. The complaint alleges that the independent trustees aided and abetted the fund's violations of the Liquidity Rule because they were aware of the facts that rendered the shares of a medical device company held by the fund illiquid, through their service on the fund's audit and valuation committees, as well as their communications with the fund's legal counsel and the fund's auditors, yet permitted the fund to classify the shares as "less liquid" for Liquidity Rule purposes. Under the Liquidity Rule, an investment is classified as "illiquid" if a fund reasonably expects that the investment cannot be sold or disposed of in current market conditions in seven calendar days or less without significantly changing the market value of the investment. An investment is classified as "less liquid" if it can be sold or disposed of in seven days or less but where the sale or disposition is expected to settle in more than seven calendar days.

The SEC complaint alleges that from June 1, 2019, the fund's compliance date for the Liquidity Rule, to at least June 16, 2020, the fund held more than 15% of its net assets in restricted shares of a medical device company that should have been classified as "illiquid" under the Liquidity Rule. Moreover, during that time, the fund failed to comply with the requirement to file Form N-LIQUID or bring its position in the restricted shares of the medical device company under the 15% threshold required by the Liquidity Rule.

The complaint may demonstrate the SEC's commitment to enforcing new rules applicable to investment companies. At the same time, the nature of the alleged conduct, which involved misrepresentations to the SEC and the resignation of both the fund's legal counsel and auditors, provide less insight into how the SEC may approach less severe deviations from the requirements of the Liquidity Rule or other newly adopted rules. Nonetheless, fund boards should take note of the staff emphasis on boards being accountable for oversight, as such oversight is required by other newly adopted rules under the Investment Company Act, including Rule 2a-5 (the Fair Value Rule) and Rule 18f-4 (the Derivatives Rule).

Allegations

The SEC asserts that there was no reasonable basis to support a classification of the fund's holdings in the medical device company as "less liquid." The complaint alleges a number of factors indicating that the fund's holdings in the medical device company should have been classified as illiquid under the Liquidity Rule, including the following:

- The fund's interests in the medical device company had significant transfer restrictions.
- In its shareholder reports and financial statements, the fund reported its interests in the medical device company as illiquid and that market quotations for interests in the company were not readily available.
- In the period leading up to the compliance date for the Liquidity Rule, both the fund's auditors and legal counsel expressed concerns about the fund's concentration in the restricted shares of the medical device company and the impending need to comply with the Liquidity Rule.
- The fund's legal counsel and auditors each recommended that the fund classify the fund's holdings in the medical device company as "illiquid" for purposes of the Liquidity Rule.
- The fund's investment in the medical device company had been subject to scrutiny by the staff of the SEC's Division of Investment Management, who in connection with reviews of the fund's public disclosure had raised questions about the fund's investment in the company and its appropriateness for investment in an open-end mutual fund. The complaint alleges that the fund's responses to questions on its public filings indicated that the investment in the medical device company was illiquid.
- The fund's written valuation procedures stated that all restricted securities are deemed to be illiquid.

Pinnacle was the program administrator for the fund's liquidity risk management program, which was adopted pursuant to the Liquidity Rule, and had the primary responsibility for monitoring the liquidity of the fund's investments and classifying the liquidity of such investments in accordance with the Liquidity Rule.

Shortly before the June 1, 2019 compliance date for the Liquidity Rule, the fund's interested trustee suggested that the interests in the medical device company could be classified as "less liquid" under the Liquidity Rule. In spite of factors noted above, the fund classified investments in the medical device company as "less liquid" rather than "illiquid." This was contrary to the advice of fund legal counsel who ultimately resigned over the issue, and the opinion of the fund's auditors who also ultimately resigned. The complaint further alleges that Pinnacle represented in a letter to the SEC that the interests in the medical device company could be classified as "less liquid" because there had been recent sales of the company's shares and investor interest due to the pending sale of the company's intellectual property, which the SEC alleges was false and misleading.

From June 1, 2019, through at least June 16, 2020, the fund held approximately 21% to more than 26% of its net assets in illiquid investments, with the largest illiquid investments being in shares of the medical device company. Only in May or June of 2020, upon the advice of the fund's new legal counsel, did Pinnacle determine to classify the fund's holdings in the medical device company as illiquid and to file Form N-LIQUID with the SEC.

Enforcement Actions

Pinnacle, the fund's officers and the independent trustees were charged with aiding and abetting the fund's violations of the Liquidity Rule. With respect to the independent trustees, the complaint alleges that through their oversight failure, they substantially assisted the fund's classification of the medical device company interests as less liquid and that they knew or recklessly disregarded that the holding was illiquid within the meaning of the Liquidity Rule. The complaint also alleges that the independent trustees violated their duties by failing to provide oversight of the fund's liquidity risk management program. The SEC is seeking to permanently enjoin the adviser, the named fund officers and the independent trustees from aiding and abetting future violations of the Liquidity Rule and is seeking an undisclosed amount of civil monetary penalties against all defendants. In a separate administrative proceeding, the fund's former interested trustee, without admitting or denying the allegations against him, agreed to cease and desist from causing future violations of the Liquidity Rule, to be suspended from certain industry roles for six months and to pay a $20,000 civil money penalty.

Sources: SEC Charges Investment Adviser and Fund Trustees with Liquidity Rule Violations, SEC Press Release 2023-90 (May 5, 2023), available here; SEC vs. Pinnacle Advisors, LLC et. al., No. 23-cv-547 (N.D.N.Y. May 5, 2023), available here.

LATEST DEVELOPMENTS: ADVISERS

SEC Staff Releases Bulletin Regarding Standards of Conduct for Broker-Dealer and Adviser Care Obligations

On April 20, 2023, the SEC staff issued a bulletin styled as questions and answers reinforcing the standards of conduct for broker-dealers and advisers (firms) in addressing their care obligations when they are providing investment advice and recommendations to retail investors. The bulletin focuses primarily on the care obligation of Regulation Best Interest for broker-dealers and the duty of care enforced under the Advisers Act for advisers and supplements previous guidance on this topic. See our July 2022 Investment Management Legal and Regulatory Update for more details.

The staff's view is that the care obligations include three intersecting components:

- Understanding the potential risks, rewards and costs associated with a product, investment strategy, account type or series of transactions;
- Having a reasonable understanding of the specific retail investor's investment profile; and
- Having a reasonable basis to conclude that the recommendation or advice provided is in the retail investor's best interest.

The staff provides additional guidance regarding how firms and their financial professionals could meet their care obligations with regards to understanding an investment or investment strategy, understanding a retail investor's investment profile, considering reasonably available alternatives, considering complex or risky investment products and considerations for dual registrants, including the points summarized below.

Understanding an Investment or Investment Strategy

- Firms and their financial professionals need to develop a sufficient understanding of the potential risks, rewards and costs of a potential investment or investment strategy to have a reasonable basis to believe it is in a retail investor's best interest, which would include an understanding of how an investment strategy fits within the context of the retail investor's investment portfolio.
- A firm and its financial professionals must consider the costs of an investment, including both direct and indirect costs that could be borne by a retail investor.
- Financial professionals have a responsibility to understand the investments or investment strategies that they are recommending independent of the firm's responsibility to understand such investments and investment strategies.

Understanding a Retail Investor's Investment Profile

- Firms and financial professionals must obtain and evaluate enough information about a retail investor to have a reasonable basis to believe that a recommendation is in the retail investor's best interest, and such evaluation may change based on the investment strategy recommended or a change in the investor's investment profile.
- Where a firm and its professionals do not have sufficient information about a retail investor's investment profile, such firm and its professionals should generally decline to provide recommendations or advice until they obtain the necessary investor information.
- A firm and its professionals should consider an investor's or account's tax status when providing advice on an investment or investment strategy relative to other options.

Considering Reasonably Available Alternatives

- In order for a firm and its financial professionals to form a reasonable basis to believe that a recommendation or advice is in a retail investor's best interest, such firms and financial professionals generally have an obligation to consider reasonably available alternatives.

- Consideration of reasonably available alternatives should not be a retroactive exercise after the firm has already decided what advice to provide.
- Firms should have a reasonable process for identifying the scope of reasonably available investment alternatives that financial professionals should consider, including guidance that defines the scope of alternatives that should be considered and the factors that should be weighed.
- A financial professional does not have to evaluate every possible alternative available through a firm but needs to evaluate a range of possible alternatives.
- Selecting the "most appropriate" alternative among limited options may not be in the best interest of a retail investor given their investment profile. A firm or financial professional may have to conclude that no investment strategy they offer is in the retail investor's best interest.
- Consideration of reasonably available alternatives may involve comparison of investment products that are not identical, but which offer similar exposure.
- Although there is no requirement to document consideration of reasonably available alternatives, it may be difficult to demonstrate compliance with obligations to retail investors without such documentation.

Complex or Risky Products

- Complex and risky products are not prohibited offerings for retail investors, but firms and their financial professionals must establish a reasonable basis to believe a product is in the best interest of the retail investor and obtain information about the retail investor that supports a conclusion that a risky or complex product is in their best interest.
- A firm's policies and procedures should be designed to address recommendations of, or advice about, complex or risky products, such as outlining the due diligence process for complex or risky products.

Recommendations and Advice By Dual Registrants

- Determining whether Regulation Best Interest or the adviser fiduciary standard applies is a facts and circumstances analysis with no one factor determinative but may involve consideration of the type of account, how the account is described, the type of compensation, and the extent to which the dually registered firm and financial professional made it clear to the retail investor the capacity in which they were acting.
- Dually registered firms and dually licensed financial professionals have an obligation to reasonably believe the advice they provide regarding account type is in a retail investor's best interest.

Source: Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Care Obligations (Apr. 20, 2023), available here.

SEC Risk Alert Highlights Key Issues in Examinations of Newly-Registered Advisers

In each year since 2013, the SEC's Division of Examinations (the Division) has included examinations of newly-registered advisers among its examination priorities. The Division has prioritized examining newly-registered advisers within a reasonable period after their registration has become effective. On March 27, 2023, the SEC published a risk alert detailing both the general scope of examinations of newly-registered advisers and staff observations from those examinations. The risk alert provides advisers with notice of key issues that the Division will emphasize in reviewing compliance policies and procedures and highlights issues that advisers may face, particularly those with fewer employees, in implementing compliance policies and procedures.

Examination Scope

Examinations of newly-registered advisers typically involve document requests and interviews to address the adviser's business and investment activities, organizational affiliations, compliance policies and procedures and disclosure to clients. The Division will generally request:

- Information about the adviser's (i) ownership, control persons, affiliations, personnel and structure (including organizational charts), (ii) eligibility for SEC registration, (iii) financial status, including financial statements, and (iv) pending, settled or threatened litigation.
- Information regarding the (i) types of services provided by the adviser, (ii) the types of accounts serviced by the adviser, (iii) the authority the adviser has over the assets in accounts they service, (iv) the personnel servicing client accounts, (v) the adviser's assets under management, (vi) the adviser's use of third-party service providers, and (vii) the types of investment strategies managed by the adviser.
- Copies of the adviser's written compliance policies and procedures, including the adviser's risk management practices, internal controls and code of ethics.
- Information to facilitate testing for regulatory compliance, including records relating to trading activities, holdings and transactions in client accounts.
- Communications used by the adviser to inform or solicit new and existing clients, including disclosure documents and advertising.

Division Observations

The Division's review of recently-registered adviser examinations identified a number of issues with respect to compliance policies and procedures, disclosure documents and marketing, including the following.

- *Compliance Policies and Procedures.* The Division identified policies and procedures that (i) did not adequately address risk areas applicable to firms, such as portfolio management and fee billing, (ii) omitted procedures to enforce stated policies, such as having a policy to seek best execution but not having procedures to articulate how the adviser will evaluate the quality of broker-dealers executing client transactions, and (iii) were not followed by advisory personnel, often because personnel were not aware of the policies. In some instances, the Division noted that these issues were caused by advisers using off-the-shelf compliance manuals that were not tailored for consistency with the adviser's operations, or by advisers not having sufficient resources devoted to compliance. The Division also noted instances of undisclosed conflicts of interest that were the result of firm personnel being assigned multiple duties, advisory firms outsourcing compliance functions without assessing performance or consistency with the adviser's adopted compliance policies and procedures, and advisers that did not have adequate business continuity plans.
- *Disclosure Documents and Filings*. The Division observed that required disclosure documents often contained omissions or inaccurate information relating to fees, affiliations, assets under management, disciplinary information, conflicts of interest, social media and websites. The Division also observed issues with required filings being made by advisers within prescribed timeframes.
- *Marketing*. The Division observed that marketing materials often contained false or misleading information, including inaccurate information about advisory personnel's professional experience or credentials, third-party rankings and performance. Advisers were also unable to substantiate certain factual claims.

Source: Observations from Examinations of Newly-Registered Advisers (Mar. 27, 2023), available here.

SEC Risk Alert Highlights Additional Areas of Emphasis for Marketing Rule Examinations

On June 8, 2023, the Division published a second risk alert focused on compliance with Rule 206(4)-1 under the Advisers Act (the Marketing Rule). The Division's first risk alert in September 2022 announced its intent to conduct examinations focused on whether advisers have (1) instituted written policies and procedures to comply with the Marketing Rule, (2) a reasonable basis to believe they will be able to substantiate material statements of fact in advertisements, (3) complied with the performance advertising requirements in the Marketing Rule, and (4) complied with the amended books and records rules. See our October 2022 Investment Management Legal and Regulatory Update for more details.

In the June 2023 risk alert, the Division shared that the staff is conducting focused examinations, as well as broad reviews, for compliance with the Marketing Rule. The staff continues to focus on the initial exam areas of review and the Division encourages advisers to review their websites and marketing materials. The staff has focused, and will continue to focus, on whether advisers have disseminated advertisements that violate any of the Marketing Rule's seven general prohibitions. The Division announced that staff will broaden their focus to include the following additional areas of emphasis.

Testimonials and Endorsements

The staff is reviewing whether:

- Testimonials and endorsements clearly and prominently disclose whether the promoter is a client or private fund investor, the promoter is compensated (if applicable), and material conflicts of interest;
- Adviser oversight and compliance conditions are met;
- Written agreements are entered into with promoters, where required; and
- Ineligible persons have been compensated for testimonials or endorsements.

Third-Party Ratings

The staff is reviewing whether:

- The advertisement clearly and prominently discloses the date on which the rating was given and the period of time upon which the rating was based, the identity of the third party that created and tabulated the rating, and that compensation has been provided by the adviser in connection with obtaining or using the third-party rating (if applicable); and
- Questionnaires or surveys used in preparation of a third-party rating meet certain conditions, such as that the adviser has a reasonable basis for believing that such questionnaire or survey is structured to make it equally easy for a participant to provide favorable and unfavorable responses.

Form ADV

The staff is reviewing whether advisers accurately completed the questions in Form ADV, Part 1, Item 5L, regarding an adviser's marketing activities.

The Division has not yet shared its observations from examinations focused on the Marketing Rule.

Source: Examinations Focused on Additional Areas of the Adviser Marketing Rule (June 8, 2023), available here.

LITIGATION AND ENFORCEMENT ACTIONS

Adviser Liable for Failure to Disclose Material Conflicts of Interest

On April 7, 2023, the United States District Court for the District of Massachusetts issued an order granting partial summary judgment for the SEC in an enforcement action brought against Commonwealth Equity Services, LLC, d/b/a Commonwealth Financial Network (Commonwealth). Commonwealth is an SEC-registered investment adviser with nearly $85 billion in assets under management, with most of Commonwealth's clients being retail investors that have less than $1 million in assets under management or a net worth of less than $2 million.

The SEC alleged that Commonwealth violated Section 206(2) of the Advisers Act by negligently failing to disclose material conflicts of interest from revenue sharing it received with respect to certain mutual fund share classes and violated Section 206(4) of the Advisers Act and Rule 206(4)-(7) thereunder by failing to adopt and implement written policies and procedures to disclose the revenue sharing compensation.

The SEC's allegations stemmed from an agreement between Commonwealth and National Financial Services, LLC (NFS), which served as a clearing firm for Commonwealth, to share in recurring fees paid by mutual funds to NFS. NFS is an affiliate of Fidelity Investments (Fidelity), which is a sponsor of mutual funds offered by NFS. Under the agreement, Commonwealth received 80% of mutual fund revenue received by NFS from assets invested in non-Fidelity funds held in Commonwealth client accounts. Commonwealth's investment adviser representatives that served as the primary portfolio managers on the Commonwealth client accounts were not given information regarding the payments that mutual fund companies made to NFS that were in turn shared with Commonwealth.

According to the complaint, this revenue sharing agreement and the inherent conflict of interest incentivized Commonwealth to invest in more expensive mutual funds that financially benefitted Commonwealth over the interests of clients, leading Commonwealth to invest client assets in more expensive mutual fund share classes that would lead to increased revenue sharing at the expense of clients.

While Commonwealth did disclose the existence of a revenue sharing agreement with NFS, the SEC alleged, and the Court agreed, that Commonwealth's disclosures of the agreement with NFS in its Form ADV were inadequate. For a significant period of time covered under the SEC's complaint, the disclosure to clients indicated that Commonwealth "may receive additional compensation" rather than including disclosure that it was actually receiving such compensation. The SEC also alleged that Commonwealth did not disclose that there were instances in which a mutual fund in NFS's no transaction fee program otherwise had a lower-cost share class available, for which Commonwealth would receive less or no revenue sharing, and that it thus had conflicts of interest associated with those investment decisions.

Commonwealth argued that it had mitigated the conflict of interest because Commonwealth's representatives had responsibility for formulating investment advice for clients and the representatives were unaware of the revenue sharing arrangement with NFS. The Court rejected Commonwealth's argument, noting that Commonwealth maintained a mutual fund recommended list and a mutual fund resource guide for its representatives. Further, the Court noted that Commonwealth ultimately retained authority to manage client assets.

The Court's decision held that Commonwealth was liable for failing to disclose these material conflicts of interest. Further, the Court rejected Commonwealth's argument that the SEC did not provide fair notice of its disclosure obligation. The SEC's initial complaint had sought disgorgement from Commonwealth, a civil penalty and an injunction restraining Commonwealth and its employees from engaging in the conduct described in the complaint. There has been no determination made with respect to an injunction, disgorgement, or civil penalty at this time.

Commonwealth has filed a motion for reconsideration and the SEC has filed a motion for final judgment.

Sources: SEC vs. Commonwealth Equity Servs., LLC, No. 19-cv-11655 (April 7, 2023), available here; SEC vs. Commonwealth Equity Servs., LLC, No. 19-cv-11655 (Aug. 1, 2019), available here.

SEC Charges Broker-Dealers with Failures to Maintain Electronic Communications

On May 11, 2023, the SEC charged two broker-dealers, HSBC Securities (USA) Inc. (HSI) and Scotia Capital (USA) Inc. (SCUSA) with failures to adhere to the recordkeeping requirements of the Securities Exchange Act in connection with internal and external communications by employees on personal devices using personal text messages or other text messaging platforms, such as WhatsApp (collectively, off-channel communications). Each enforcement action also involved a related claim against the applicable broker-dealer for failing to implement its policies and procedures in a manner that constituted a failure to reasonably supervise its employees. In each order, the SEC noted that the firm had self-reported the recordkeeping failures and began remediation efforts.

The rules adopted under the Securities Exchange Act require that broker-dealers preserve in an easily accessible place originals of all communications received and copies of all communications sent relating to the firm's business. With respect to both HSI and SCUSA, the SEC found that the firm failed to preserve employees' off-channel communications relating to the firm's business.

The complaints against HSI and SCUSA are very similar. The SEC noted that both HSI and SCUSA had policies and procedures designed to ensure the retention of business-related records. Both HSI and SCUSA had advised employees that use of unapproved electronic communications, including on personal devices, was not permitted, and that employees should not use personal email, chats or text messaging applications for business purposes.

The SEC found that employees of each of HSI and SCUSA had longstanding and widespread failures to adhere to the recordkeeping requirements of the Securities Exchange Act in regards to the use of personal devices for off-channel communications. In each enforcement action, the SEC found that the use of personal devices for off-channel communications was occurring at all levels within the firm.

To settle the charges, each of HSI and SCUSA acknowledged that their conduct violated the Securities Exchange Act recordkeeping requirements and agreed to pay penalties of $15 million and $7.5 million, respectively. In addition, each of HSI and SCUSA agreed to a series of undertakings which included the retention of a compliance consultant to, among other things, review the firm's policies and procedures relating to electronic communications, review the training conducted by the firm regarding preservation of electronic communications, and assess the firm's surveillance of electronic communications and efforts to prevent the use of unauthorized communications. In addition, each firm agreed for a period of two years following the order to notify the SEC of any discipline imposed by the firm in connection with violations of policies and procedures concerning the preservation of electronic communications.

Although the orders were against broker-dealers for failure to retain off-channel communications, advisory firms should also be cognizant of their recordkeeping requirements under the Advisers Act, which requires retention of all written communications received and copies of all written communications sent relating to recommendations made or advice given. SEC Chair Gensler has indicated in public comments that the SEC will use sweep exams and other initiatives to review advisers' use of off-channel communications, including WhatsApp. Accordingly, advisers should take note of the need to either prohibit the use of off-channel communications or consider how they will monitor and retain records relating to business-related off-channel communications. In addition, advisers should ensure that they are training employees regarding the firm's policies and procedures relating to electronic communication and prohibited forms of electronic communication.

Sources: SEC Charges HSBC and Scotia Capital with Widespread Recordkeeping Failures, SEC Press Release 2023-91 (May 11, 2023), available here; In the Matter of HSBC Securities (USA) Inc., File No. 3-21408 (May 11, 2023), available here; In the Matter of Scotia Capital (USA) Inc., File No. 3-21409 (May 11, 2023), available here.

COMPLIANCE DATES FOR FINAL RULES

Final Rules	Compliance Dates
Amendments to Form N-PX and Say-on-Pay Vote Disclosure	Rule and form amendments effective for votes occurring on or after July 1, 2023, with the first filings subject to the amendments due August 31, 2024 for the 12-month period ended June 30, 2024
Shareholder Reports, Rule 30e-3 Amendments and Amended Advertising Rules	Rule and form amendments effective January 24, 2023, with a compliance date of July 24, 2024

STATUS OF PROPOSED RULES

Proposed Rules for Funds and Advisers	Status
Cybersecurity Risk Management for Investment Advisers, Registered Investment Companies, and Business Development Companies	Comments were due by May 22, 2023. The SEC has not taken any further action as of the date of publication.
Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices	Comments were due November 1, 2022. The SEC has not taken any further action as of the date of publication.
Proposed Rules for Funds	**Status**
Investment Company Names	Comments were due November 1, 2022. The SEC has not taken any further action as of the date of publication.
Open-End Fund Liquidity Risk Management Programs and Swing Pricing; Form N-PORT Reporting	Comments were due February 14, 2023. The SEC has not taken any further action as of the date of publication.
Proposed Rules for Advisers	**Status**
Modernization of Beneficial Ownership Reporting	Comments were due on June 27, 2023. The SEC has not taken any further action as of the date of publication.
Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews	Comments were due November 1, 2022. The SEC has not taken any further action as of the date of publication.
Outsourcing by Investment Advisers	Comments were due December 27, 2022. The SEC has indicated a final rule will be issued in April 2024.
Safeguarding Advisory Client Assets	Comments were due May 8, 2023. The SEC has not taken any further action as of the date of publication.
Regulation S-P: Privacy of Consumer Financial Information and Safeguarding Customer Information	Comments were due June 5, 2023. The SEC has not taken any further action as of the date of publication.