GODFREY & KAHN

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Investment Management Legal and Regulatory Update

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LATEST DEVELOPMENTS

SEC Adopts Rule Amendments to Regulation S-P to Enhance Protection of Customer Information

On May 16, 2024, the SEC adopted amendments to Regulation S-P, the regulation protecting privacy of consumer financial information that was first adopted over twenty years ago. The amendments are intended to strengthen protections of customer information by requiring funds, registered advisers, broker-dealers, and transfer agents (Covered Institutions) to adopt a reasonably designed incident response program and require customer notification in certain instances.

The amendments focus on two provisions (the safeguards and disposal rules) that have become outdated due in large part to technological advancements that have changed how firms obtain, store and share individuals' nonpublic personal information.

The safeguards rule (Rule 248.30(a) under Regulation S-P) currently requires Covered Institutions (excluding transfer agents) to adopt written policies and procedures for administrative, technical and physical safeguards to protect customer records and information. The disposal rule (Rule 248.30(b) under Regulation S-P) currently requires Covered Institutions (including transfer agents) to properly dispose of consumer information and customer information.

The amendments broaden and align these rules to cover both nonpublic personal information that a Covered Institution collects about its customers *and* the nonpublic personal information they receive from other financial institutions about customers of that entity. The amendments also create a federal minimum standard for Covered Institutions to provide data breach notifications to affected individuals.

Customer Information

The amendments adopt a new term, "customer information" defined as "any record containing nonpublic personal information […] about a customer of a financial institution, whether in paper, electronic or other form". The term applies to information that a Covered Institution possesses, handles or maintains (excluding transfer agents).

Incident Response Program

The amended safeguards rule requires Covered Institutions to adopt an incident response program to respond to unauthorized access to or use of customer information, as well as to prevent against such unauthorized activities.

The amendments require incident response plans to be reasonably designed to detect, respond to, and recover from unauthorized access to or use of customer information. In particular, an incident response program must include procedures to:

- assess the nature and scope of any incident involving unauthorized access to or use of customer information and identify the customer information systems and types of customer information that may have been accessed or used without authorization;
- take appropriate steps to contain and control the incident to prevent further unauthorized access to or use of customer information; and
- notify each affected individual whose "sensitive customer information" (a defined subset of customer information) was, or is reasonably likely to have been, accessed or used without authorization (as discussed below). "Sensitive customer information" is defined to include, among other things, information identifying an individual's account (e.g., the account number or name of the account), and information used to authenticate the account (e.g., an access code or partial social security number).

Customer Notification Requirements

The amendments further require Covered Institutions to provide notices to individuals whose sensitive customer information was, or was reasonably likely to have been, accessed or used in an unauthorized manner.

Covered Institutions are required to notify affected individuals as soon as practicable, but no later than 30 days, after becoming aware of the unauthorized access to or use of customer information has occurred or is reasonably likely to occur, unless the Covered Institution determines that, after reasonable investigation, the sensitive customer information has not been (and is not reasonably likely to be) used in a manner that would substantially harm or inconvenience the individuals. The "as soon as practicable" standard may be based on several factors, including the time needed to assess, control and contain an incident.

Notices must include details about the incident, the unauthorized information accessed, and how affected individuals can respond to protect themselves.

Service Provider Oversight

The amendments to the safeguards rule also require Covered Institutions (as part of their incident response programs) to adopt, maintain and enforce written policies and procedures that are reasonably designed to require oversight of service providers, including through due diligence and monitoring. "Service provider" is defined in the amendments as "any person or entity that receives, maintains, processes, or otherwise is permitted access to customer information through its provision of services directly" to a Covered Institution. For example, Service Providers include an affiliate of a Covered Institution if an affiliate is permitted to access information though provision of services under this definition.

In particular, incident response plans must ensure that service providers take proper steps to:

- protect against unauthorized access to, or use of, customer information; and
- notify the Covered Institution as soon as possible (but no later than 72 hours) after becoming aware that a security breach occurred and resulted in authorized access to customer information.

After the receipt of this notification, Covered Institutions are required to initiate their incident response plans.

Other Information

The amendments to Regulation S-P also:

- amend the safeguards and disposal rules to cover nonpublic personal information that Covered Institutions: (1) collect about their own customers; and (2) receive from another financial institution about customers of that entity;
- require Covered Institutions to establish and maintain written records related to the requirements of the safeguards and disposal rules;
- codify an exception to the annual delivery requirements for privacy notices; and
- extend the requirements of the safeguards and disposal rules to transfer agents.

Compliance

The rule amendments are effective August 2, 2024, with tiered compliance dates:

- Larger Entities (funds with net assets of $1 billion or more, registered advisers with assets under management of $1.5 billion or more, and broker-dealers and transfer agents that are not small entities under the Securities Exchange Act of 1934): December 21, 2025.
- Smaller Entities (covered institutions that do not meet the "larger entity" thresholds): June 21, 2026.

Godfrey & Kahn Note: In addition to revisions of fund and adviser privacy policies and information security policies and procedures, the amendments to Regulation S-P provide an opportunity to review and update, if necessary, other related policies and procedures, including, for example, policies related to service provider oversight and procedures related to customer notification.

Sources: Regulation S-P: Privacy of Consumer Financial Information and Safeguarding Customer Information, SEC Final Rule (May 16, 2024), available here, and as corrected, available here; SEC Adopts Rule Amendments to Regulation S-P to Enhance Protection of Customer Information, SEC Press Release 2024-58 (May 16, 2024), available here; Final Rules: Enhancements to Regulation S-P, SEC Fact Sheet (May 15, 2024), available here.

LATEST DEVELOPMENTS: ADVISERS

SEC's Private Fund Adviser Rules Struck Down by the Fifth Circuit

On June 5, 2024, the Fifth Circuit Court of Appeals issued its opinion striking down the SEC's private fund adviser rules (PFA Rules) in their entirety. The PFA Rules would have regulated a wide range of activities and imposed significant new disclosure requirements on private fund sponsors. In a unanimous decision, the court found that the SEC exceeded its statutory authority by adopting the PFA Rules. The statutory authority on which the SEC relied to adopt the PFA Rules is contained in Sections 211(h) and 206(4) of the Advisers Act.

Because the PFA Rules were vacated in full, the rules have no effect and private fund advisers are not subject to any of the rules' requirements. In addition, because one of the provisions of the PFA Rules required written compliance reviews by registered investment advisers, this requirement was also vacated as a result of the Fifth Circuit's decision.

Background

Prior to the passage of the Dodd-Frank Act in 2010, private fund advisers were generally exempt from registration under the Advisers Act. In 2010, the Advisers Act "private adviser" exemption was eliminated, subjecting many private fund advisers to registration. This registration included reporting and recordkeeping requirements under the Advisers Act. Over a decade later, after working extensively with institutional investor and private investment fund manager communities, the SEC adopted the PFA Rules in August 2023. The PFA Rules sought to impose significant additional disclosure requirements and prohibitions on private fund advisers relating to the granting of preferential treatment to fund investors, expense and performance reporting, annual audit requirements, and fee and expense allocations. In response, several industry groups challenged the PFA Rules in the Fifth Circuit Court of Appeals.

The Fifth Circuit's Decision

In adopting the PFA Rules, the SEC relied upon its authority set forth in Sections 211(h) and 206(4) of the Advisers Act. Section 211(h), which was added in 2010 when Congress passed the Dodd-Frank Act, grants the SEC rulemaking authority to facilitate the provision of simple and clear disclosures to investors regarding, among other things, the terms of their relationships with investment advisers, including any material conflicts of interest, and to prohibit or restrict certain sales practices, conflicts of interest, and compensation schemes that the SEC deems contrary to the public interest and protection of *investors*. The SEC argued that the use of the word "investors" in Section 211(h) as opposed to "retail investors" conveyed congressional intent to cover both retail investors and more sophisticated private fund investors. In addition to Section 211(h), the SEC relied upon the preexisting antifraud authority provided in Section 206(4) of the Advisers Act, which authorizes the SEC to define and prescribe means reasonably designed to prevent fraudulent, deceptive, or manipulative practices by investment advisers.

Rejecting the SEC's argument, the Fifth Circuit unanimously concluded that the SEC exceeded its statutory authority under the Advisers Act, and found that neither Section 211(h) nor Section 206(4) authorized the adoption of the PFA Rules. The court held that Section 211(h) "has nothing to do with private funds" because it applies to "retail customers" only. The court also found that the PFA Rules were not supported by the SEC's general antifraud authority under Section 206(4) because the SEC had not articulated a "rational connection" between fraud and any part of the PFA Rules. The court also concluded that Section 206(4) does not authorize the SEC to require disclosure and reporting, because "where Congress wanted to provide for" the reporting and disclosure of certain information, it did so explicitly.

What's Next

At this point, the SEC has the option to either seek *en banc* review with the full Fifth Circuit or appeal the Fifth Circuit's decision to the U.S. Supreme Court. Neither of these seems likely to occur. Instead, it is possible that the SEC may go back to the drawing board and re-propose a new set of private fund adviser rules which address the concerns raised by the Fifth Circuit. If the SEC decides to take this approach, it will likely be some time before new rules intended to regulate private fund advisers are re-proposed.

Nevertheless, commentary from the SEC in the adopting release for the PFA Rules regarding an investment adviser's fiduciary duties is still indicative of the SEC's views on this topic. For example, the adopting release explicitly confirmed the SEC's position that advisers cannot waive their fiduciary duty or seek reimbursement for breaches of such duty and, importantly, its view that a breach of fiduciary duty may arise from conduct constituting mere negligence. Likewise, the SEC made clear in the adopting release that it views an adviser's receipt of fees for unperformed services (e.g., accelerated monitoring fees) as contrary to the adviser's fiduciary duty, even where there is disclosure and investor consent. The vacatur of the PFA Rules does not necessarily change the SEC's position on these matters. Accordingly, an adviser that has not done so already should review its governing documents and disclosures to ensure that they are in step with the SEC's position.

The Fifth Circuit's decision also has potential implications for other SEC proposed rulemakings that rely, at least in part, on Section 211(h) of the Advisers Act. For example, the authority for pending proposals relating to outsourcing, cybersecurity risk management and the use of predictive data analytics (e.g., artificial intelligence (AI)), each of which rely in part on Section 211(h), are all in question as a result of the decision.

Godfrey & Kahn Note: We will continue to monitor this matter and provide updates as they become available.

Source: National Association of Private Fund Managers et al. v. Securities and Exchange Commission, No. 23-60471, at 17-18 (5th Cir. June 5, 2024), available here.

SEC Risk Alert Regarding Advisers Act Marketing Rule Compliance and Enforcement Actions

On April 17, 2024, the SEC Division of Examinations (Division) issued a risk alert related to amended Rule 206(4)-1 under the Advisers Act (the Marketing Rule). The risk alert is the third risk alert issued by the Division in the last two years. The previous risk alerts are summarized in our July 2023 and October 2022 Updates.

The Division issued this risk alert to share observations and information regarding advisers' compliance with the Marketing Rule. The Division shared the observations to encourage advisers to accurately report information related to the Marketing Rule on Form ADV and to promote compliance with relevant provisions of the Advisers Act.

Rule 206(4)-7 (the Compliance Rule)

The Division observed written policies and procedures that would likely prevent violations of the Advisers Act, including the Marketing Rule, such as preapproval of, and processes for, reviewing advertisements and training on firm policies and Marketing Rule requirements. However, the Division also observed policies and procedures that would likely *not* prevent violations of the Advisers Act, noting that such policies and procedures were not:

1. written with specific explanations or expectations related to the Marketing Rule;
2. tailored to specific marketing platforms used by advisers;
3. in writing;
4. updated to reflect particular marketing topics;
5. written to reflect advisers' specific advertisements;
6. written to properly address preservation and maintenance of advertisements and supporting documentation; or
7. effectively implemented.

Books and Records Rule

The Division observed examples of failures to maintain and preserve copies of:

1. surveys and questionnaires used to prepare third-party ratings;
2. information posted to social media platforms; and
3. information to support performance information used in advertisements.

Form ADV

The Division also examined advisers' Form ADV submissions and observed inaccurate submissions and reporting in Part 1A (Item 5.L) and Part 2A (Item 14). In Part 1A, the Division observed advisers who inaccurately reported that their advertisements did not include the use of third-party ratings, performance results and/or hypothetical performance. In Part 2A firm brochures, the Division observed the use of outdated language such as references to the old cash solicitation rule (Rule 206(4)-3 under the Advisers Act was rescinded), and inaccurate information regarding referral arrangements.

General Prohibitions of the Marketing Rule

The Division also shared its observations regarding compliance with the general prohibitions of the Marketing Rule. In particular, the Division observed: (1) untrue statements of material fact; (2) statements of material fact unable to be substantiated; (3) omissions of material facts or misleading inferences of information that implied or suggested untrue or misleading statements of facts; (4) failure to provide a fair and balanced treatment of disclosure relating to specific investment advice, material risks or limitations, and/or performance results; and (5) otherwise materially misleading advertisements.

Marketing Rule Enforcement Actions

The SEC recently announced settlements with five advisers for advertising hypothetical performance on their websites without adopting policies and procedures reasonably designed to ensure the performance disclosure was appropriate for the likely financial situation of potential investors. This is the SEC's second collection of cases brough as part of its ongoing sweep regarding Marketing Rule violations (see our October 2023 Update that discusses the SEC's settlements with nine advisers for hypothetical performance advertisements on their websites).

The press release stated that certain advisers:

1. advertised false and misleading performance claims;
2. failed to present net and gross performance information;
3. were unable to substantiate performance claims;
4. failed to enter into agreements with individuals being compensated for making endorsements;

5. made misleading statements that were included in a fund's prospectus;
6. failed to preserve and maintain books and records to support performance information; and
7. failed to annually review and implement policies and procedures.

Each adviser agreed to settle with the SEC, and pay civil penalties generally ranging from $20,000 to $30,000, with one adviser agreeing to pay $100,000.

Sources: Initial Observations Regarding Advisers Act Marketing Rule Compliance, SEC Risk Alert (Apr. 17, 2024), available here; SEC Charges Five Investment Advisers for Marketing Rule Violations, SEC Press Release 2024-46 (Apr. 12, 2024), available here.

The New DOL Fiduciary Rule

On April 23, 2024, the U.S. Department of Labor (DOL) released its new final Retirement Security Rule (the Final Rule) defining who is an investment advice fiduciary under the Employee Retirement Income Security Act (ERISA). The DOL also released final amendments to certain prohibited transaction class exemptions (PTEs), including PTE 2020-02. The Final Rule and amendments to the PTEs generally take effect on September 23, 2024, with a one-year transition period for certain conditions in the PTEs.

Definition of an Investment Advice Fiduciary. The Final Rule focuses on the nature of the relationship between an adviser and a retirement investor (including, for example, an employee benefit plan, a plan participant or beneficiary, and an individual retirement account (IRA)), and it extends to the types of interactions retirement investors commonly have with financial advisers. Under the Final Rule, a person will be an investment advice fiduciary under ERISA if:

- the person makes an investment recommendation to a retirement investor;
- the recommendation is provided for a fee or other compensation, such as commissions; and
- the person holds itself out as a trusted adviser by specifically stating that it is acting as a fiduciary under ERISA, or by making the recommendation in a way that would indicate to a reasonable investor that it is acting as a trusted adviser making individualized recommendations based on the investor's best interest.

Most investment advisers will satisfy these criteria when making investment recommendations to retirement investors and, therefore, will be required to rely on a PTE in order to receive compensation for their services.

Notably, the Final Rule retains the same three exceptions to what types of interactions with retirement investors constitute recommendations—*i.e.,* so-called "hire-me" communications, education, and unsolicited rollovers.

Amendments to PTE 2020-02. In connection with the adoption of the Final Rule, the DOL also adopted certain amendments to PTE 2020-02. Under the amended PTE 2020-02, the following four conditions must be satisfied:

1. *Impartial Conduct Standards*: Investment recommendations must adhere to the "impartial conduct standards," which means that:
    - the advice must meet obligations of care and loyalty;
    - the investment professional and firm must charge no more than reasonable compensation and comply with applicable federal securities laws regarding "best execution;" and
    - the advice must be free from misleading statements about investment transactions and other relevant matters.
2. *Pre-Transaction Disclosures*: At or before the time the recommended transaction occurs, the firm must provide written disclosures consisting of:
    - a fiduciary acknowledgement;

- a description of the obligations of care and loyalty;
- all material facts concerning fees, type and scope of services;
- all material facts relating to conflicts of interest; and
- for rollover recommendations from an ERISA plan, documentation regarding the specific reasons for the recommendation. This last requirement does not apply to rollovers from tax qualified non-ERISA plans, such as a solo 401(k) plan, nor does it apply to IRA transfers.

3. *Policies and Procedures*: The firm must maintain and enforce policies and procedures designed to ensure compliance with the Impartial Conduct Standards and other PTE conditions.
4. *Annual Retrospective Review*: The firm must conduct a retrospective review at least annually (and no later than six months after the end of the review period) to detect and prevent violations of the Impartial Conduct Standards and other PTE conditions. The review must be reduced to a written report certified by a senior executive officer of the firm.

Amended PTE 2020-02 is partially effective September 23, 2024, but only for the Impartial Conduct Standards and the fiduciary acknowledgement. The remaining conditions of amended PTE 2020-02 are effective on September 23, 2025.

Comparison to the DOL 2016 Fiduciary Rule. In 2016, the DOL finalized an updated investment advice fiduciary definition (the 2016 Rule), granted new prohibited transaction exemptions, including the Best Interest Contract Exemption, and amended some pre-existing exemptions. However, in 2018, the Fifth Circuit Court of Appeals struck down the 2016 Rule as too broad and as exceeding the DOL's authority. The definition of investment advice fiduciary in the Final Rule is more narrowly tailored than the 2016 Rule, which applied to virtually all paid recommendations to retirement investors. The Final Rule limits fiduciary status to recommendations made by persons who effectively hold themselves out as occupying a position of trust and confidence with respect to the retirement investor, as described above.

Challenges to the Final Rule. Shortly after adoption, the Federation of Americans for Consumer Choice, Inc. (FACC) along with several additional plaintiffs filed a complaint in the Eastern District of Texas seeking to overturn the Final Rule. More recently, nine insurance trade associations filed suit in the Northern District of Texas seeking a preliminary injunction on the implementation of the Final Rule. Both of these courts are in the Fifth Circuit Court of Appeals, which is the Court that had overturned the 2016 Rule. These cases are currently pending.

Godfrey & Kahn Note: Advisers will need to review and update their policies and procedures and disclosures (including Form ADV) as needed to comply with the new requirements of amended PTE 2020-02.

Sources: Retirement Security Rule: Definition of an Investment Advice Fiduciary, RIN 1210-AC02 (Apr. 25, 2024), available here; Retirement Security Rule and Amendments to Class Prohibited Transaction Exemptions for Investment Advice Fiduciaries, U.S. DOL Fact Sheet (Apr. 23, 2024), available here; Amendment to Prohibited Transaction Exemptions 75-1, 77-4, 80-83, 83-1, and 86-128, ZRIN 1210-ZA34 (Apr. 25, 2024), available here; Amendment to Prohibited Transaction Exemption 2020-02, ZRIN 1210-ZA32 (Apr. 25, 2024), available here; FACC et al. vs DOL, No. 6:24-cv-00163 (May 2, 2024), available here; American Council of Life Insurers et al. vs. DOL, No. 4:24-cv-00482 (May 24, 2024), available here.

DOL Finalizes Changes to the QPAM Exemption

In response to changes in the financial sector, the U.S. Department of Labor (DOL) has finalized changes to the qualified professional asset manager (PTAM) exemption in PTE 84-14 (the QPAM Exemption). As described below, QPAMs currently relying on the QPAM Exemption must provide notice of reliance to the DOL by September 14, 2024.

Background

ERISA generally prohibits transactions between plans and any "party in interest," i.e., a person or entity closely connected to employee benefit plans governed by ERISA. The IRC includes parallel provisions that also apply to ERISA plans and IRAs. Absent a statutory, regulatory, or administrative exemption, these rules prohibit the provision

of services between plans and these parties (e.g., the plan custodian or investment adviser).

The QPAM Exemption is a prohibited transaction class exemption that provides broad relief for ERISA plan and IRA transactions that otherwise would be prohibited by ERISA and the IRC, as long as the transactions involve a QPAM and satisfy certain protective conditions. The QPAM Exemption does not exempt any transaction in which the QPAM itself is self-dealing or acting to promote its own financial interests at the expense of a plan. The rationale for the QPAM Exemption is that the potential for conflicts of interest is reduced when transactions involving plan and IRA assets are handled by an independent asset manager of sufficient size to protect against improper influence.

Summary of the Final Amended QPAM Exemption

The final amended QPAM Exemption includes:

1. clarification that foreign convictions are included in the scope of the QPAM Exemption's ineligibility provision;
2. expansion of the QPAM Exemption's ineligibility provision to include additional types of misconduct;
3. updated asset management and equity thresholds in the QPAM definition (to $101,956,000 and $1,346,000, respectively, as adjusted);
4. clarification of the requisite independence and control a QPAM must have with respect to investment decisions and transactions; and
5. addition of a standard recordkeeping requirement.

Reporting Reliance on the QPAM Exemption

Effective June 17, 2024, the final amendment requires QPAMs to report their reliance on the QPAM Exemption to the DOL, including the legal name of the entity and any name the QPAM may be operating under, within 90 days. There is also a 90-day correction period for inadvertent failures to provide the notice. The DOL will publish a list of notifying QPAMs on its website.

Godfrey & Kahn Note: QPAMs should review the final amended QPAM Exemption and update their policies and procedures regarding determining eligibility, providing notices, and satisfying recordkeeping requirements accordingly.

Sources: Amendment to Prohibited Transaction Class Exemption 84-14 for Transactions Determined by Independent Qualified Professional Asset Managers (the QPAM Exemption), 89 FR 23090 (Apr. 3, 2024), available here; Fact Sheet: Final Amendment to PTE 84-14 – the QPAM Exemption (Apr. 2024), available here.

SEC and FinCEN Propose CIP Requirements for Advisers

On May 13, 2024, the SEC and the U.S. Treasury Department's Financial Crimes Enforcement Network (FinCEN) jointly proposed a new rule under the Bank Secrecy Act (BSA) that would require advisers (both registered investment advisers and exempt reporting advisers) to establish, document and maintain written customer identification programs (CIPs). The proposed rule is intended to strengthen anti-money laundering and countering the financing of terrorism (AML/CFT) frameworks for advisers.

The proposed rule would require advisers to implement reasonable procedures to verify (through documentary and/or non-documentary methods) the identity of their customers (to the extent reasonable and practicable) and that such verification occur within a reasonable time before or after the customer's account is opened, in order to form a reasonable belief that advisers know the true identity of their clients. Under the proposed rule, advisers would also be required to provide customers adequate notice of such identity verification procedures. The proposal also requires advisers to maintain records of their client identification information including (at a minimum) the client's full legal name, date of birth, address and other identifying information (e.g., social security number). The proposed rule would also require that the CIP include reasonable procedures for determining whether a customer appears on any list of known or suspected terrorists or terrorist organizations provided by any federal government agency that is designated as such by the U.S. Treasury.

The proposal seeks to make it more difficult for criminal, corrupt or illicit actors to establish customer relationships (including using false identities) with advisers for the purposes of financing terrorism, laundering money or participating in other illegal finance activity. The proposed CIP requirements for advisers are largely consistent with the CIP requirements for other financial institutions, including open-end investment companies and broker-dealers.

The proposal complements a separate FinCEN proposal from February 2024 that is intended to address regulatory gaps in AML/CFT programs for registered and exempt investment advisers. This proposal adds advisers to the definition of "financial institutions" under the BSA, thereby subjecting them to AML/CFT program obligations and suspicious activity report (SAR) filing requirements. Our April 2024 Update contains further details regarding this separate proposal.

The comment period for the proposed CIP rule for advisers closes on July 22, 2024.

Sources: SEC, FinCEN Propose Customer Identification Program Requirements for Registered Investment Advisers and Exempt Reporting Advisers, SEC Press Release 2024-54 (May 13, 2024), available here; Customer Identification Programs for Registered Investment Advisers and Exempt Reporting Advisers, Release No. BSA-1, File No. S7-2024-02, available here; Customer Identification Programs, SEC and FinCEN Fact Sheet (May 13, 2024), available here.

LITIGATION/ENFORCEMENT ACTIONS

Supreme Court Limits SEC In-House Enforcement Authority in *SEC v. Jarkesy*

On June 27, 2024, the U.S. Supreme Court issued its opinion of *SEC v. Jarkesy*. The Supreme Court found that enforcement before a SEC in-house administrative law judge (ALJ) violates the right to a jury trial. The Supreme Court reasoned that federal securities law fraud is similar to common law fraud that implicates the Seventh Amendment right to a jury trial.

In *Jarkesy*, the SEC pursued an in-house enforcement action against George Jarkesy Jr., an investment adviser, and his firm alleging securities law fraud in 2013. In 2014, the presiding ALJ sided against Mr. Jarkesy and his firm. In 2020, the SEC issued a final order, imposing penalties. Mr. Jarkesy petitioned the U.S. Court of Appeals for the Fifth Circuit (Fifth Circuit) for review of the order. The Fifth Circuit held that enforcement before the SEC's ALJ violated the right to a jury trial. In 2023, the Supreme Court granted certiorari to review the Fifth Circuit's opinion regarding the SEC's in-house enforcement authority (see our January 2024 Update for a summary of oral arguments before the Supreme Court). The Supreme Court's review resulted in a 6-3 vote affirming the Fifth Circuit's opinion.

The opinion was written by Chief Justice Roberts, while Justices Gorsuch and Thomas concurred, and Justices Sotomayor, Kagan, and Jackson dissented.

Godfrey & Kahn Note: As a result of the ruling, the SEC must bring enforcement actions seeking penalties before juries in U.S. federal courts, instead of before in-house ALJs, which will likely be significantly more burdensome for the agency. The Supreme Court's decision also calls into question the ability of other federal agencies to seek civil penalties through administrative proceedings.

Source: SEC v. Jarkesy et al., No. 22-859 (June 27, 2024), available here.

SEC Obtains Jury Verdict in "Shadow Trading" Insider Trading Case

The SEC has successfully prosecuted a new theory of insider trading known as "shadow trading." On April 5, 2024, a jury in the U.S. District Court for the Northern District of California found Matthew Panuwat liable for insider trading. The SEC argued that liability for "shadow trading" arises when an individual, in breach of a fiduciary duty owed to the source of the information, uses material, nonpublic information (MNPI) pertaining to one company to trade in the securities of a separate company that is economically linked to the first company.

The SEC had filed a civil complaint against Mr. Panuwat in 2021, alleging that he misappropriated confidential information of his employer to purchase stock options in another company. Mr. Panuwat was employed as a senior director of business development with Medivation, a mid-cap, oncology-focused biopharmaceutical company. During 2016, Mr. Panuwat was involved in confidential discussions regarding the acquisition of Medivation by another pharmaceutical company. Minutes after receiving an email from the CEO of Medivation that Pfizer had expressed

"overwhelming interest" in acquiring Medivation, Mr. Panuwat purchased stock options of Incyte, a competitor of Medivation. A few days later, Medivation signed a merger agreement with Pfizer and Mr. Panuwat earned over $100,000 in profits on his Incyte options investment after the deal was publicly announced. The SEC complaint noted that Incyte's stock price rose by approximately 8% following the acquisition announcement.

The SEC alleged that Mr. Panuwat engaged in illegal insider trading in violation of Section 10(b) of the Securities Exchange Act of 1934 and brought an action under the misappropriation theory of insider trading. A person violates the law under the misappropriation theory when they knowingly misappropriate MNPI for securities trading purposes, in breach of a duty owed to the source of the information. Mr. Panuwat argued he could not be liable under this theory because the information about the acquisition of Medivation was material as to Medivation, but not to Incyte, the issuer of the securities he traded in.

In a 2022 decision denying Mr. Panuwat's motion to dismiss, the U.S. District Court for the Northern District of California determined that information "may be material to more than the two companies specifically engaged in the transaction." The court found that "the SEC has sufficiently pleaded that the information about Medivation's looming acquisition was material to Incyte." In a 2023 decision denying Mr. Panuwat's motion for summary judgment, the court noted that Medivation and Incyte were similarly situated biopharmaceutical companies and that analyst reports and financial news articles commonly linked Medivation's acquisition to Incyte's future value.

The case went to a jury trial in March 2024, and the jury found Mr. Panuwat liable for insider trading. Gurbir Grewal, Director of the SEC's Enforcement Division, released a statement following the jury verdict dismissing the idea that the case stands for a new theory of insider trading: "As we've said all along, there was nothing novel about this matter, and the jury agreed: this was insider trading, pure and simple."

Godfrey & Kahn Note: Investment advisers and broker-dealers may wish to review their insider trading policies in light of the *Panuwat* case to prohibit trading in the securities of economically linked companies when an individual is in possession of MNPI about another company. The court notably cited the language in Medivation's insider trading policy in supporting the SEC's allegation that Mr. Panuwat breached a duty of trust and confidence to Medivation. The policy addressed MNPI regarding Medivation as well as relating to "the securities of another publicly-traded company." In addition, investment advisers and broker-dealers should ensure that insider trading policies cover trading in options and other derivative instruments as well as public company stock. The SEC alleged that Mr. Panuwat did not seek pre-clearance of his trades in the Incyte options.

Sources: Complaint, SEC v. Panuwat, No. 21-CV-06322-SK (N.D. Cal. Aug. 17, 2021), available here; Order Denying Motion to Dismiss, SEC v. Panuwat, No. 21-CV-06322-WHO, 2022 WL 633306 (N.D. Cal. Jan. 14, 2022); Order Denying Motion for Summary Judgement, SEC v. Panuwat, No. 21-CV-06322-WHO, 2023 WL 9375861 (N.D. Cal. Nov. 20, 2023); Gurbir S. Grewal, Statement on Jury's Verdict in Trial of Matthew Panuwat, SEC (Apr. 5, 2024), available here.

SEC Enforcement Action Against RIA Relating to Off-Channel Communications

On April 3, 2024, the SEC announced a settlement with Senvest Management, LLC (Senvest) related to the adviser's recordkeeping failures, failures to implement firm policies and procedures, and failures to abide by, and enforce, the firm's code of ethics. Senvest was ordered to pay a civil penalty in the amount of $6.5 million.

The SEC order indicated that Senvest employees (including those in supervisory roles) used personal texting platforms and other non-Senvest electronic communication services (i.e., off-channel communications) to communicate about business-related matters, in violation of Senvest's policies and procedures (which required the firm to "retain all electronic communications that it sends and receives"). A substantial majority of these communications were not properly preserved and maintained by Senvest, as required by the Advisers Act. The order noted that three senior employees used personal devices that were "set to automatically delete messages after 30 days" to communicate about business-related matters, thereby preventing Senvest, and the SEC, from accessing and properly preserving such business communications. The order specifically highlighted that Senvest's compliance manual strictly prohibited employees from using non-Senvest electronic communication services for any business purpose.

The SEC order also indicated that Senvest personnel engaged in personal securities transactions without obtaining proper pre-clearance, as required by Senvest's code of ethics, and Senvest supervisors failed to review personal securities transactions on a timely basis, as required by Senvest's pre-clearance policy.

Godfrey & Kahn Note: Previously, the SEC settled with sixteen broker-dealer and investment advisory firms for similar failures as discussed in our April 2024 Update. The enforcement action against Senvest is the first enforcement action against a standalone adviser and further illustrates the SEC's focus on off-channel communications violations.

Sources: SEC Charges Advisory Firm Senvest Management with Recordkeeping and Other Failures, SEC Press Release 2024-44 (Apr. 3, 2024), available here; In the Matter of Senvest Management, LLC, Release No. IA-6590, Administrative Proceeding File No. 3-21900 (Apr. 3, 2024), available here.

SEC Enforcement Action Against Adviser for "Pay-to-Play" Rule Violations

On April 15, 2024, the SEC announced a settlement with an adviser for violations of Rule 206(4)-5 under the Advisers Act (the Pay-to-Play Rule). The Pay-to-Play Rule, in part, prohibits advisers from providing investment advisory services for compensation to a government entity within two years after such adviser, or one of its covered associates, makes a contribution to a state or local official of the government entity, including candidates for election.

The order provides that a covered associate of Wayzata Investment Partners LLC (Wayzata) contributed to the campaign of a candidate for elected office, whose office had influence over selecting investment advisers for a state investment board. The state investment board had previously invested in private equity funds advised by Wayzata, and Wayzata continued to provide advisory services for compensation to these funds within the two years after the contribution, in which the state investment board remained an investor. The amount of the contribution was $4,000. The SEC found that Wayzata willfully violated the Pay-to-Play Rule and ordered, among other things, payment of a civil monetary penalty in the amount of $60,000.

SEC Commissioner Hester M. Peirce dissented to the settlement of this action noting that Wayzata's violations did not originate from an attempt to obtain additional investments from the state investment board, rather the violations stemmed from the fact that Wayzata continues to provide advisory services for compensation in connection with the state investment board's historical investments in the firm's private equity funds. Commissioner Peirce criticized the Pay-to-Play Rule's role in hampering legitimate political participation by employees of advisers by discouraging such employees from making campaign contributions altogether (either by choice or by a firm's policies and procedures). She noted that the "concerns about public corruption underlying the [Pay-to-Play Rule] are worthy of attention," but wanted to bring to light the chilling and penalizing effect the Pay-to-Play Rule may have on political participation.

Godfrey & Kahn Note: This enforcement action serves as a good reminder to advisers to be extra vigilant regarding their pay-to-play policies during the 2024 election season.

Sources: SEC Charges Investment Adviser for Pay-To-Play Violation Involving a Campaign Contribution, AP Summary (Apr. 15, 2024), available here; There's Got to Be a Better Way: Statement of Dissent Regarding Wayzata Investment Partners LLC, Commissioner Hester M. Peirce (Apr. 15, 2024), available here; In the Matter of Wayzata Investment Partners LLC, Rel. No. IA-6590, Administrative Proceeding File No. 3-21914 (Apr. 15, 2024), available here.

OTHER NEWS OF INTEREST

Federal Ban of Effectively all Existing and Future Non-Competes

On April 23, 2024, the Federal Trade Commission (FTC) published a final rule that effectively bans all existing and future non-compete agreements for U.S. workers, with limited exceptions. The FTC's ban on employers imposing or seeking to enforce non-competes goes into effect on September 4, 2024. The final rule: (1) requires employers to affirmatively notify current and former workers (excluding a limited class of "senior executives") that their non-competes are not enforceable as of September 4, 2024; and (2) prohibits all future non-competes on or after the final rule's effective date.

Private lawsuits have been filed challenging the FTC's authority to issue the final rule and its enforceability. For example, a federal court in Texas granted a stay of the effective date of the rule, effectively postponing it, and a preliminary injunction enjoining the FTC from implementing or enforcing the rule. The court found that there is "substantial likelihood" that the rule is "arbitrary and capricious because it is unreasonably overbroad without a reasonable explanation."

Godfrey & Kahn Note: A more complete summary of the final rule and take-aways businesses should consider now are included in our April 2024 Firm News. We will continue to monitor this matter and provide updates as they become available.

Source: Federal Trade Commission Bans Non-Competes and Lawsuits Follow: 5 Take-aways Businesses Should Consider Now, Godfrey & Kahn Firm News (Apr. 26, 2024), available here; Ryan LLC v. Federal Trade Commission, No. 3:24-CV-00986-E (July 3, 2024), available here.

COMPLIANCE REMINDERS

T+1 Settlement Cycle | Compliance Impact on Advisers

As of May 28, 2024, the new rule and rule amendments related to the new T+1 settlement cycle went into effect. In connection with these amendments, the SEC amended certain recordkeeping requirements for advisers in Rule 204-2 under the Advisers Act (the Books and Records Rule).

The SEC adopted rule amendments to shorten the standard settlement cycle for most broker-dealer transactions from T+2 to T+1 in February 2023. The SEC also adopted a new Rule 15c6-2 under the Securities Exchange Act of 1934. The new rule impacts the processing of institutional trades by requiring broker-dealers and clearing agencies engaging in the allocation, confirmation or affirmation process with another party to achieve settlement of securities transactions subject to the T+1 settlement cycle to either: (1) enter into a written agreement; or (2) establish, maintain and enforce policies and procedures. Both the written contract and policies and procedures requirements are intended to ensure completion of the allocation, confirmation or affirmation process as soon as technologically possible and no later than the end of the trade date.

Rule 204-2(a)(7)(iii) of the Books and Records Rule was also amended to require advisers, in connection with any confirmation, allocation or affirmation subject to Rule 15c6-2, to keep records of: (1) each confirmation received; and (2) any allocation and each affirmation sent *or* received (including date and time stamps for each allocation and affirmation). The amendments require such records to be kept in the same manner and for the same period of time as other books and records required to be kept under Rule 204-2.

Godfrey & Kahn Note: The recent compliance date for the new rule and amendments serves as a good reminder for advisers to review and update, if necessary, their trading and books and records policies and procedures.

Sources: Shortening the Securities Transaction Settlement Cycle, SEC Division of Examinations Risk Alert (Mar. 27, 2024), available here; New “T+1” Settlement Cycle–What Investors Need To Know, SEC Investor Bulletin (Mar. 27, 2024), available here; Shortening the Securities Transaction Settle Cycle, Release Nos. 34-96930 and IA-6239 (May 5, 2023), available here.

Form N-PX Filing | Compliance Reminders for Investment Companies and Advisers Filing Form 13F

In November 2022, the SEC adopted rule and form amendments that: (1) expand the proxy voting information investment companies, including mutual funds, ETFs and certain other funds (collectively, funds) are required to report on Form N-PX; and (2) require each adviser filing Form 13F (a Form 13F filer) to annually report, on Form N-PX, how it voted on executive compensation proposals.

The filing deadline is August 31, 2024 for both funds and Form 13F filers for votes covering the 12-month period ended June 30, 2024.

Fund Requirements

Funds are required to report the following expanded proxy voting information on Form N-PX:

- Use the same language used in, and presented in the same order as, an issuer’s proxy card to identify proxy voting matters;
- Organize the subject matter of each of the reported proxy voting matters using a specified list of categories, such as director/trustee elections, extraordinary transactions and “say-on-pay” matters;

- Disclose (1) the number of shares voted, or instructed to be voted, and how such shares were voted, and (2) the number of shares loaned (but not recalled to vote); and
- Provide Form N-PX disclosure separately by series for fund complexes that offer multiple series.

Funds must disclose that their proxy voting record is publicly available on (or through) their websites and available upon request without charge.

Form 13F Filer Requirements

Form 13F filers are required, for the first time, to annually report on Form N-PX how it voted proxies on:

- Approval of executive compensation ("say-on-pay" votes);
- Approval of the frequency of executive compensation approval votes ("say-on-frequency" votes); and
- Approval of "golden parachute" compensation in connection with mergers and acquisitions.

Unlike funds, Form 13F filers are not required to disclose on their websites that their proxy voting records are publicly available.

More information on the rule and form amendments is discussed in our January 2023 Update.

Sources: SEC Adopts Rules to Enhance Proxy Voting Disclosure by Registered Investment Funds and Require Disclosure of "Say-on-Pay" Votes for Institutional Investment Managers, SEC Press Release 2022-198 (Nov. 2, 2022), available here; Enhanced Reporting of Proxy Votes by Registered Management Investment Companies; Reporting of Executive Compensation Votes by Institutional Investment Managers, Release Nos. 33-11131, 34-96206 and IC-34745 (Nov. 2, 2022), available here; Amendments to Form N-PX and Say-on-Pay Vote Disclosure, SEC Fact Sheet (Nov. 2, 2022), 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 by August 31, 2024 for the 12-month period ended June 30, 2024.
Investment Company Tailored Shareholder Reports, Rule 30e-3 Amendments and Amended Advertising Rules	Rule and form amendments were effective January 24, 2023, with a compliance date of July 24, 2024.
Investment Company Names Rule Amendments	Larger fund groups (net assets of $1 billion or more): December 11, 2025 Smaller fund groups (net assets of less than $1 billion): June 11, 2026
Corporate Transparency Act	Subject entities in existence on January 1, 2024 must file an initial report by December 31, 2024. Entities created on or after January 1, 2024 must file an initial report within 30 days after receiving notice of their creation or registration.
Modernization of Beneficial Ownership Reporting	▪ Schedule 13G filing deadline: September 30, 2024 ▪ Compliance with the structured data requirement: December 18, 2024
Regulation S-P: Privacy of Consumer Financial Information and Safeguarding Customer Information*	Rule amendments are effective August 2, 2024, with tiered compliance dates: Larger Entities (investment companies with net assets of $1 billion or more, registered advisers with assets under management of $1.5 billion or more, and broker-dealers and transfer agents that are not small entities under the Securities Exchange Act of 1934): December 21, 2025. Smaller Entities (covered institutions who do not meet the “larger entity” thresholds): June 21, 2026.
DOL Retirement Security Rule*	The final rule is effective September 23, 2024 (with a one-year transition period for certain requirements).
DOL QPAM Exemption*	Firms relying on the QPAM Exemption must file notice by September 14, 2024.

STATUS OF PROPOSED RULES

Proposed Rules for Funds and Advisers	Status
Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices	The SEC has indicated final rules will be issued in October 2024.
Cybersecurity Risk Management for Investment Advisers, Registered Investment Companies, and Business Development Companies	The SEC has indicated final rules will be issued in October 2024.
Proposed Rules for Funds	**Status**
Open-End Fund Liquidity Risk Management Programs and Swing Pricing; Form N-PORT Reporting	New rule proposal expected in April 2025.
Proposed Rules for Advisers	**Status**
Outsourcing by Investment Advisers	The SEC has indicated final rules will be issued in October 2024.
Safeguarding Advisory Client Assets	New rule proposal expected in October 2024.
Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers	New rule proposal expected in October 2024.
Customer Identification Program Requirements for Registered Investment Advisers and Exempt Reporting Advisers*	Comments due July 22, 2024.

**Discussion included in this IM Update.*