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Regulatory Update

Investment Management Regulatory Update

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Regulatory Actions

SEC Adopts Names Rule Amendments

Investment Advisers | Investment Companies

On September 20, 2023, the SEC adopted amendments to Rule 35d-1 (the "Names Rule") to expand the scope of fund names that will require adoption of an 80% investment policy. The amendments will apply to fund names "suggesting that the fund focuses in investments that have, or investments whose issuers have, particular characteristics," including terms such as growth or value and certain terms that reference a thematic investment focus, such as terms indicating that the fund's investment decisions incorporate environmental, social, and governance (ESG) factors. In addition to the expanded scope, the amendments also make certain changes to operations of the Names Rule, including:

- A fund with derivatives holdings will be required to use the derivatives' notional amount, rather than their market value, for the purpose of determining the fund's compliance with its 80% investment policy.
- A fund will be required to review compliance with its 80% investment policy at least quarterly.
- A fund that departs from its 80% investment policy in "other than normal circumstances" will be required to return to compliance within 90 days.
- A fund with an 80% investment policy will be required to define in its prospectus the terms used in its name, including the criteria the fund uses to select the investments that the term describes. The amendments clarify that such definitions must be "consistent with those terms' plain English meaning or established industry use."
- An unlisted registered closed-end fund or business development company will not be able to change its 80% investment policy without a shareholder vote.
- The amendments impose new recordkeeping and compliance provisions.

- The amendments modernize the notice requirements for changes to a fund's 80% investment policy including with respect to notifications delivered electronically.

The compliance date for the final amendments is December 10, 2025, for larger entities, and June 10, 2026, for smaller entities. For purposes of the compliance date, smaller entities are funds that together with other investment companies in the same "group of related investment companies" have net assets of less than $1 billion as of the end of the most recent fiscal year. The adopting release is available here.

SEC Adopts Rule Changes for Private Funds and Private Fund Advisers

Investment Advisers | Private Funds

On August 23, 2023, the SEC adopted new and amended rules under the Advisers Act requiring advisers to private funds to provide additional disclosures to investors in such funds, restrict certain types of preferential treatment to investors, and impose new requirements related to fund audits, books and records, and adviser-led secondary transactions. Specifically, the final rulemaking will, among other things:

- Require registered private fund advisers to provide investors with quarterly statements including information about fund performance, fees, and expenses.
- Require registered private fund advisers to obtain an annual audit of each advised fund by an independent registered public accountant.
- Require registered private fund advisers, in connection with an adviser-led secondary transaction, to obtain and distribute to investors a fairness opinion or a valuation opinion and a written summary of certain material relationships between the adviser and the opinion provider.
- Restrict all private fund advisers (whether registered or not) from engaging in certain specified activities and practices described by the SEC as "contrary to the public interest and the protection of investors" unless the adviser provides appropriate specified disclosure and, in some cases, obtains investor consent, subject to certain exceptions.
- Restrict all private fund advisers from providing preferential treatment to certain investors and not others, unless the activities meet certain exceptions and the adviser provides required disclosures.
- Require all registered advisers, including those that do not advise private funds, to document the annual review of their compliance policies and procedures in writing.

Compliance with the amended Advisers Act compliance rule will be required as of November 13, 2023. The compliance dates for other provisions of the reform range from 12-18 months from the date of publication in the Federal Register (September 14, 2023) and vary based on the particular rule, each adviser's registration status, and, in some cases, the amount of private fund assets under management attributable to the adviser. For more information, please see our client alert available here.

SEC Adopts Money Market Fund Reform

Registered Funds | Investment Advisers | Money Market Funds

On July 12, 2023, the SEC adopted a series of amendments to Rule 2a-7 under the Investment Company Act of 1940 ("Rule 2a-7") governing the operations of money market funds. Amended Rule 2a-7, which was paired with related form amendments, is intended to make money market funds more "resilient, liquid, and transparent, including in times of stress." The amendments were adopted largely as proposed with a notable exception: the SEC declined to adopt a proposal requiring certain money market funds to implement swing pricing. In its place, the SEC adopted a fee framework intended to allocate costs to redeeming investors during periods of high redemptions. Industry reaction to the adopted reforms has been largely positive due to the removal of the swing pricing proposal and elimination of the liquidity fees and gates structure imposed in 2014.

In particular, the reforms:

- Remove the regulatory tie between the imposition of liquidity fees and a fund's liquidity level and remove provisions from the current rule that permit a money market fund to temporarily suspend redemptions during periods of high redemption activity (*i.e.,* fees and gates);
- Impose a mandatory liquidity fee when an institutional prime or institutional tax-exempt money market fund experiences net redemptions above 5% of its net assets;
- Increase the daily and weekly minimum liquidity requirements for all money market funds;
- Revise the liquidity metrics used by money market funds in required stress tests;
- Permit money market funds to address a negative interest rate environment either by converting from a stable share price to a floating share price or by reducing the number of shares outstanding to maintain a stable net asset value per share; and
- Enhance reporting requirements for money market funds and large advisers of liquidity funds.

Compliance with the amended daily and weekly minimum liquidity requirements as well as changes to the metrics for stress testing is required by April 2, 2024. Compliance with the mandatory and discretionary liquidity fee requirements will be required by October 2, 2024. Compliance with certain of the amended reporting requirements will be required by June 11, 2024. The remaining amendments required compliance by October 2, 2023. The adopting release can be found here.

SEC Adopts Changes to Beneficial Ownership Reporting Requirements

Public Companies | Investment Companies | Other Market Entities

On October 10, 2023, the SEC adopted amendments to modernize the rules governing beneficial ownership reporting by:

- Shortening the period required for filing Schedule 13D from 10 days to 5 business days for an initial filing and requiring that amendments be filed within 2 business days;
- Shortening the period required for qualified institutional investors and exempt investors to file an initial Schedule 13G from 45 days after the end of a calendar year to 45 days after the end of the calendar quarter in which the investor beneficially owns more than 5% of the covered class;
- Shortening the period required for passive investors to file an initial Schedule 13G from 10 days to 5 business days;
- Requiring that amendments to Schedule 13G be filed within 45 days after the end of the calendar quarter in which a material change occurred (except for a qualified institutional investor or passive investor whose beneficial ownership exceeds 10% or increases or decreases by 5%, which would be subject to an accelerated filing schedule);
- Clarifying that a person is required to disclose interests in all derivative securities (including cash-settled derivative securities) that use an issuer's equity security as a reference security on Item 6 of Schedule 13D;
- Providing guidance clarifying when the use of cash-settled derivatives securities constitutes beneficial ownership of a reference security for purposes of Rule 13d-3 (the guidance is similar to guidance issued by the SEC regarding the treatment of security-based swaps); and
- Providing guidance clarifying that an expressed agreement is not required for persons to be a considered a "group" for purposes of Sections 13(d)(3) and 13(g)(3) of the Exchange Act and related beneficial ownership disclosure requirements.

The amendments will become effective 90 days after publication in the Federal Register. Compliance with the revised Schedule 13G filing deadlines will be required beginning on September 30, 2024. The adopting release can be found here.

SEC Adopts Cybersecurity Rules

Public Companies | *Other Market Entities*

On July 26, 2023, the SEC adopted rule and form amendments that will require firms to:

- Disclose on Form 8-K (or 6-K, as applicable) any material cybersecurity incidents within four (4) business after the company determines that it has experienced a material cybersecurity incident, absent a "substantial risk to national security or public safety." Reporting obligations will begin on December 18, 2023 (except for smaller reporting entities, which will begin reporting on June 15, 2024).
- Disclose on an annual basis on Form 10-K or Form 20-F material information regarding their cybersecurity risk management, strategy, and governance practices beginning with annual reports for fiscal years ending on or after December 15, 2023.

The adopted rule and form amendments are narrower in scope than those originally proposed in March of 2023 and streamline the information required in the annual cybersecurity reporting. The text of the final rule is available here.

SEC Proposes Regulation of Internet Advisers

Investment Advisers | *Other Market Entities*

The SEC proposes to amend Rule 203A-2(e) to narrow the exemption that permits investment advisers operating through the internet to register with the SEC instead of with the applicable states. If adopted, the proposed amendments would:

- Require an investment adviser relying on the exemption to at all times have an operational interactive website through which the adviser provides investment advisory services; and
- Eliminate the current rule's de minimis exception for non-internet clients (internet advisers are currently permitted fewer than 15 non-internet clients).

The comment period for the proposed rule closed on October 2, 2023. The proposing release can be found here.

SEC Proposes Regulation of Adviser and Broker-Dealer Use of Predictive Analytics

Investment Advisers | *Broker-Dealers* | *Other Market Entities*

The SEC proposes that registered advisers and registered broker-dealers be required to identify, evaluate, and mitigate any conflicts of interest associated with the use of "covered technologies" in connection with investor communications or solicitations. A conflict of interest would exist when a firm uses a covered technology that takes into consideration an interest of the firm or its associated persons. The rule would also require that firms develop compliance policies and procedures and keep books and records designed to achieve compliance with the proposal, including a written description of the process for evaluating the use of a covered technology and the process for determining how to mitigate any conflicts of interest. For purposes of the proposed rule, "covered technology" includes a firm's use of analytical, technological, or computational functions, algorithms, models, correlation matrices, or similar methods or processes that optimize for, predict, guide, forecast, or direct investment-related behaviors or outcomes of an investor.

Comments on the proposed rule were due on October 10, 2023. The proposing release is available here.

SEC Proposes Enhancements to Customer Protection Rule for Broker-Dealers

Broker-Dealers | Other Market Entities

The SEC proposes amendments to Rule 15c3-3, the rule that protects a customer's cash and securities held at a broker-dealer, to increase the frequency (from weekly to daily) of the computation of the cash that certain large broker-dealers must maintain in their reserve accounts. Under the current rule, broker-dealers that maintain custody of customers' securities and cash are required to maintain a reserve bank account with securities or cash in an amount determined by a computation of the net cash owed to covered customers. Broker-dealers are currently required to assess the amounts and make required deposits on a weekly basis. If adopted, the proposed amendments would require broker-dealers with average total credits equal to or greater than $250 million to make the relevant computations daily, as of the close of the previous business day. A broker-dealer's average total credits would be calculated on a rolling 12-month basis based on total credits reported in the broker-dealer's 12 most recently filed month-end FOCUS reports.

The comment period for the proposed rule closed on September 11, 2023. The proposing release can be found here.

Market Happenings

D.C. Circuit Court Vacates SEC's Bitcoin ETF Denial

Investment Advisers | Investment Companies | Private Funds

On August 29, 2023, the U.S. Court of Appeals for the D.C. Circuit issued its much-anticipated opinion in favor of Grayscale Investments, LLC's petition for review of the SEC's denial of NYSE Arca's application (the "Grayscale Application") for a rule change under Rule 19b-4 under the Securities Exchange Act of 1934. The Grayscale Application, if approved, would permit the listing of shares of the $16 billion Grayscale Bitcoin Trust (ticker: GBTC) and represent an important step toward its eventual conversion into an ETF. The D.C. Circuit vacated the SEC's disapproval of the Grayscale Application, reasoning that Grayscale and NYSE Arca "presented substantial evidence that Grayscale is similar, across the relevant regulatory factors," to the exchange-traded products that hold bitcoin futures contracts that the SEC previously approved under the same legal standard. The decision suggested that the SEC did not sufficiently defend its decision to approve bitcoin futures ETFs while denying spot bitcoin ETFs. While the SEC has not acted on Grayscale Application, it did not appeal the court's decision.

The D.C. court's opinion is available here.

Litigation, Enforcement, and Examinations

SEC Issues Annual Examination Priorities for 2024

Investment Advisers | Investment Companies | Broker-Dealers | Other Market Entities

On October 16, 2023, the SEC's Division of Examinations issued its annual examination priorities for 2024. The Division will continue its focus on compliance with certain newly implemented rules and regulations, such as the derivatives rule for investment companies and the marketing rule for investment advisers as well as a more general focus on investment advisers to private funds. The Division outlined specific priorities with respect to investment advisers' fiduciary duties and compliance programs and investment companies' valuation practices, oversight of fees and expenses and compliance with exemptive order conditions, among other things. The Division also noted several risk areas impacting various market participants, including: (i) cyber and information security and operational resiliency for advisers and broker-dealers (including risks presented by third-party vendors); (ii) crypto assets and emerging financial technologies (including use of artificial intelligence, automated investment tools, and trading algorithms and platforms); and (iii) broker-dealer and investment companies' anti-money laundering programs. Notably, the Division no longer included environment, social, and governance investing as a priority for examination.

The Division's complete 2024 Examination Priorities Report is available here.

SEC Settles Enforcement Actions Relating to the Marketing Rule

Investment Advisers

On September 11, 2023, the SEC announced the settlement of charges against nine investment advisers for violating Section 206(4) and Rule 206(4)-1(d) of the Advisers Act (the "Marketing Rule") by utilizing hypothetical performance in their advertisements to mass audiences without implementing policies and procedures required by the Marketing Rule. This enforcement action follows the precedent action the SEC took on August 21, 2023, against a fintech investment adviser that had allegedly misrepresented hypothetical performance of its investments in violation of the Marketing Rule. Collectively, these enforcement actions represent the first agency actions to hold firms accountable for violations of the new Marketing Rule.

The SEC's press release is available here.

SEC Issues Risk Alert Regarding Adviser Examinations

Investment Advisers

On September 6, 2023, the SEC issued a risk alert outlining the Division of Examinations' risk-based approach for selecting advisers and risk areas for examination. According to the risk alert, in addition to the advisers that fall under one or more of the Division's annual examination priorities, the Division may consider firm-specific factors when selecting firms, such as:

- The length of time since the firm's registration or last examination and prior examination observations and conduct, especially firms the Division believes to have a history of significant, deficient practices;
- Supervisory concerns, such as disciplinary history of associated individuals or affiliates;
- Tips, complaints, or referrals involving the firm;
- Business activities of the firm or its personnel that may create conflicts of interest, such as outside business activities and the conflicts associated with advisers dually registered as, or affiliated with, brokers;
- Changes to the firm, including material changes in the firm's leadership or other personnel, or similar indications that the adviser might be vulnerable to financial or market stresses or news stories that may involve or impact the firm;
- Data provided by certain third-party data services;
- Disclosure history of the firm; and
- Whether the firm has access to client and investor assets and/or presents certain gatekeeper or service-provider compliance risks.

The Division noted that focus areas and information requested will vary from examination to examination depending on the reasons for and focus areas of the examination, but examinations will typically include review of the advisers' operations, disclosures, conflicts of interest, and compliance practices with respect to certain core areas, including custody and safekeeping of client assets, valuation, portfolio management, fees and expenses, and brokerage and best execution.

The risk alert is available here.

SEC Issues Enforcement Action for Failure to Locate Lost Securityholders

Transfer Agents | Investment Companies | Other Market Entities

On August 17, 2023, the SEC issued an enforcement order fining DST Asset Manager Solutions, Inc., a registered transfer agent for mutual fund complexes, in the amount of $500,000 and potentially created a new disclosure obligation for DST's mutual fund clients. The SEC alleged that DST "fail[ed] to take reasonable steps to find lost securityholders" in violation of Exchange Act Rule 17Ad-17, which resulted in the escheatment of customers' assets. The rule sets forth certain minimum requirements for transfer agents to locate lost securityholders, including requiring

transfer agents to conduct periodic database searches to ascertain the addresses of lost securityholders and to implement policies and procedures for ensuring compliance with the rule. The SEC alleged that DST's policies and procedures, which included database searches, were insufficient to address the requirements of the rule. In addition to the fine, the SEC's order requires DST to request that its mutual fund clients "periodically send out notifications to their client shareholder base informing them of the risk of escheatment and educating them on steps to take to avoid dormancy, including updating their addresses and otherwise establishing contact with the funds or DST." DST must also provide written proof of compliance. Critics of the SEC's order, including two SEC commissioners, suggest that the order essentially creates a new disclosure obligation for mutual funds not otherwise required by regulation or statute.

The SEC's order is available here. A statement from the two commissioners criticizing the order is available here.

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If you would like further information concerning the matters discussed in this article, please contact a member of Chapman's Corporate and Securities Department or the Investment Management Group or visit us online at chapman.com.