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Investment Management Regulatory Update - May 2023

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In this issue, we discuss an SEC Examinations Division risk alert on LIBOR-transition preparedness, an SEC staff bulletin on standards of conduct for investment advisers and a recent enforcement action involving liquidity rule violations.

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Rules and regulations

SEC adopts amendments to bolster private fund reporting

The SEC's amendments to Form PF include new event reporting requirements for large hedge fund advisers within 72 hours of the occurrence of certain events, and for private equity fund advisers within 60 days of the fiscal quarter end; and revised reporting requirements for large private equity fund advisers. Please see our recent client update for more information on this topic.

NY Attorney General seeks broad authority over digital assets

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The NY Attorney General is seeking legislation that would significantly expand the state's reach over digital assets and require wholesale changes to the operation of digital asset businesses that choose to remain in New York. Please see our recent client update for more information on this topic.

Industry update

SEC Examinations Division issues risk alert on observations from examinations of investment advisers and investment companies concerning LIBOR-transition preparedness

On May 11, 2023, the Division of Examinations (Examinations Division) issued a risk alert on its observations from examinations relating to the preparedness of registered investment advisers and investment companies (firms) for the anticipated discontinuation of the London Interbank Offered Rate (LIBOR). Firms examined by the Examinations Division included: (i) advisers associated with large bank complexes; (ii) advisers to various types of registered investment companies (i.e., mutual funds, closed-end funds, exchange-traded funds, and business development companies); (iii) small, medium and large fund complexes; (iv) advisers to private funds that invest in private credit, such as collateralized loan obligations; and (v) large retail-oriented advisers. The Examinations Division had the following observations:

- **Risk management**: Examinations Division staff observed that firms with significant LIBOR exposure generally treated the LIBOR transition as an enterprise risk governance matter, and formed cross-functional working groups overseen by risk governance committees, created detailed transition plans and completed comprehensive impact assessments on investment and operational exposures. Almost all firms examined by the staff were either members of the Alternative Reference Rates Committee (ARRC) or relied on its guidance. The staff observed that firms have also taken steps to ensure that relevant personnel are kept informed about the LIBOR transition and any internal policies, procedures or guidance.
- **Operations**: The staff noted that firms have worked with service providers, sub-advisers and third-party managers to assess their transition readiness and performed end-to-end testing to confirm that their internal systems can accommodate alternative reference rates (ARRs).
- **Portfolio management**: The staff observed that many firms have adopted a global approach to identifying LIBOR exposure, looking across subsidiaries and affiliates. Most firms utilized internal tools to track and monitor LIBOR and ARR exposure on a real-time or periodic basis. The staff noted that many firms used third-party service providers to review LIBOR-linked contracts and identify fallback provisions, or the lack thereof.
- **Fiduciary responsibilities and investor communications**: The staff observed that firms with large direct client exposure addressed their fiduciary obligations by remediating contracts, while firms with indirect exposure have conducted due diligence on third-party fund managers' transition readiness. The staff noted that firms have examined conflicts of interest related to the transition, such as cross-trading, principal transactions, allocation of transition costs and clients with conflicting priorities. The staff observed that firms with significant LIBOR exposure have provided comprehensive disclosure on the risks associated with the transition, such as legal, operational, credit and regulatory risks. The staff also observed that firms utilized a wide range of client communication methods, depending on their businesses and determinations of the level of information that would be relevant for clients.
- **Keeping informed about ongoing and new challenges**: The staff noted that firms have generally stayed informed about the ongoing and new challenges of the transition, and highlighted the following:
  - **"Transitioning bank loans in advance of June 30, 2023.** The ARRC has encouraged market participants to remediate as many outstanding LIBOR-linked bank loans as practicable before the cessation date, to avoid a flood of contracts requiring individually negotiated amendments in mid-2023."
  - **"Complex contracts and synthetic LIBOR.** A few complexes identified highly complex LIBOR-linked contracts that: (i) are issued overseas and not subject to the Adjustable Interest Rate (LIBOR) Act of 2021, and (ii) where no fallback language exists and/or transition via an amendment process is impracticable. It is likely that many of these contracts will now transition to a synthetic LIBOR."
  - **"Operational challenges associated with June 30, 2023 cessation date.** Firms noted significant operational complexities associated with the conversion of LIBOR-linked contracts that will be transitioning, whether by hardwired fallback provisions, an amendment process, or the LIBOR Act for legacy contracts with no or impracticable fallback provisions (tough legacy). Firms recommended continued monitoring of the ARRC and other industry resources for guidance and tools in addressing these complexities."

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The Examinations Division concluded by reminding firms to be aware of the challenges that exist to a smooth and orderly transition away from LIBOR and encouraging them to act in accordance with their fiduciary obligations throughout the transition process.

SEC staff issues bulletin on standards of conduct for broker-dealers and investment advisers in addressing their care obligations

The SEC staff issued a bulletin in a FAQ format, which laid out the standards of conduct for broker-dealers and investment advisers in addressing their care obligations when they are providing investment advice and recommendations to retail investors. For investment advisers, this focused primarily on providing practical guidance on the considerations necessary to satisfy the fiduciary duties owed to retail investors under the Investment Advisers Act of 1940 when providing investment advice and recommendations. Such guidance provided by the SEC staff addressed the following general care obligations and some special considerations:

- Understanding the potential risks, rewards and costs associated with investments or investment strategies.
- Having a reasonable understanding of the investor's investment profile.
- Based upon the above, a consideration of reasonable available investment alternatives, which provide a reasonable basis to conclude that the recommendation or advice provided is in the retail investor's best interest.
- Issues when recommending complex or risky products.
- Firms that have dual-registration as broker dealers and advisory firms.

Understanding the investment or investment strategy

The SEC staff provided the following guidance with regards to an investment adviser's understanding of the investments or investment strategies they recommend.

- Prior to providing advice and recommendations on investments and investment strategies to retail investors, investment advisers must understand such investments and investment strategies, including their potential risks, rewards and costs. Without this understanding, investment advisers cannot have a reasonable basis to believe that their recommendations or advice aligns with the retail investor's investment profile such that the specific recommendation or advice given is in the investor's best interest.
- Investment advisers must consider a mixture of factors in order to understand the investments and investment strategies, though the specific factors that should be considered to form a reasonable basis vary based on facts and circumstances. The SEC staff listed the following as a non-exhaustive list of important factors relating to the investments and investment strategies that may be relevant to consider:
  - Investment objectives (e.g., providing income, principal protection, exposure to a market sector, long or short term)
  - Initial and ongoing costs (including direct, indirect and potential costs)
  - Key characteristics and risks, or other features that may impact the investment
  - Likely performance in a variety of market and economic conditions
  - Expected returns, expected payout rates, potential losses
  - Special or unusual features
  - Role of the investment or investment strategy within the retail investor's actual or anticipated investment portfolio
- Total potential costs over the retail investor's expected time horizon are a relevant factor to consider, including costs beyond those disclosed on a trade confirmation or account statement. These could include transaction costs, sales loads or charges, fees, trading and other costs associated with an investment strategy, exit costs and impact on the investor.
- Financial professionals may not rely solely on their firm's diligence and approval process for investments and investment strategies to satisfy their own care obligations, and must personally understand the investments and investment strategies they recommend.

Understanding the retail investor's investment profile

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The SEC staff provided the following guidance with regards to an investment adviser's understanding of a retail investor's investment profile.

- In order to build an investment profile, an investment adviser should make reasonable efforts to obtain sufficient information about the retail investor to have a reasonable basis to believe that the recommendations or advice provided are in the best interests of that specific investor. The investment adviser must have a reasonable basis to believe that such information is not materially inaccurate, incomplete or outdated. What constitutes sufficient information varies based on the facts and circumstances, but should typically include the following information:
  - Financial situation and needs
  - Investments
  - Assets and debts
  - Marital status
  - Tax status
  - Age
  - Investment time horizon
  - Liquidity needs
  - Risk tolerance
  - Investment experience
  - Investment objective and financial goals
  - Other information the retail investor may disclose
- Investment advisers may need to update the investor's investment profile in order to ensure they are making recommendations and giving advice that fits the investor's current circumstances.
- If investor information is unavailable despite the investment adviser's reasonable efforts to obtain it, to the extent that the investment adviser does not have sufficient understanding of the retail investor to form a reasonable belief that the recommendation or advice they would give is in the best interest of the investor, the investment adviser must generally decline to provide recommendations or advice. If the investment adviser decides not to obtain certain information that is customarily included, they should consider documenting the basis for believing that such information is not relevant in light of the facts and circumstances.
- When retail investors have particular tax statuses or goals, investment advisers should consider whether the investment or investment strategy recommended is in the best interest of the retail investor, as different investments and investment strategies provide different tax advantages.

Considering reasonably available alternatives

The staff noted that the SEC has stated that advisers have a duty to act in the best interest of the client that cannot be satisfied through disclosure alone, and that the SEC has brought enforcement actions against investment advisers for failing to consider certain available alternatives when selecting or recommending investments for their clients. As such, the SEC staff provided the following guidance.

- Investment advisers must consider alternative investments or investment strategies that are reasonably available to achieve the investor's investment objectives. Such consideration should start early in the process of formulating a recommendation or providing advice, in order for the investment adviser to have a reasonable belief that the recommendation or advice given is in the investor's best interest. When investment advisers provide ongoing advice or services, the evaluation of available alternatives too must continue throughout the investment period.
- Firms should have reasonable processes for establishing and understanding the scope of available alternatives that their investment advisers should consider. This process should generally begin by considering a broader array of investments or investment strategies that are generally consistent with the retail investor's investment profile, which can then be narrowed down. Firms should provide guidance such as policies and training to their investment advisers that defines the scope of alternatives that should be considered and the factors that should be weighed in evaluating available alternatives.

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- When a firm has a very broad scope of available alternatives, investment advisers are not obligated to review every possible alternative available. However, they must evaluate a range of available alternatives sufficiently broad to serve as a reasonable basis to believe that a recommendation or advice is in the best interest of the retail investor.
- When a firm has a limited list of available investments or investment strategies, investment advisers should generally be familiar with them all. If the list is so short that a given investment or investment strategy has no available alternatives within the list in light of a retail investor's particular investment profile, the investment adviser should consider whether other investment options may be available that may better serve the client's interests.
- If a firm has a limited list of available investments or investment strategies, none of which are consistent with a retail investor's particular investment profile, investment advisers cannot fulfill their care obligations simply by recommending the closest fit.
- Investments or investment strategies that are not identical and that may have unique features can still be considered alternatives to each other depending on the retail investor's investment profile. Investment advisers should look to the retail investor's investment profile and the comparative risks, rewards and costs in determining what investments and investment strategies constitute available alternatives.
- Investment advisers must consider the risks, rewards and costs associated with the reasonably available alternatives, as such aspects factor into a reasonable basis to believe that a recommendation or advice is in a retail investor's best interest. If the investment adviser ultimately recommends an investment or investment strategy that is at a higher cost or risk than available alternatives, they must have a reasonable belief that it is in the investor's best interest despite such heightened cost or risk.
- Firms may wish to document the evaluation of available alternatives, as it may otherwise be difficult for a firm to demonstrate compliance with its obligations to retail investors or assess the adequacy and effectiveness of its written policies and procedures. This is particularly relevant when recommendations or advice seem inconsistent with the retail investor's investment objectives on its face or pose conflicts of interest for the firm or investment adviser.

Complex or risky products

- It is possible for investment advisers to satisfy their care obligations while recommending or providing advice about complex or risky products, so long as they have established a reasonable basis to believe such products are in the best interest of the retail investor in light of their particular investment profile. They should, however, apply heightened scrutiny to such products, and consider whether less complex, less risky or lower cost alternatives can achieve the same objectives.
- Heightened scrutiny for a complex or risky product involves understanding the particularities of the product's features and obtaining information about the retail investor that supports a conclusion that a complex or risky product is in that retail investor's best interest, such as identifying an investor-specific objective that is consistent with the product's description in its prospectus or offering documents, and information that the investor can withstand heightened risk of financial loss.
- Firms should implement procedures that outline the due diligence process for complex or risky financial products, and ensure that appropriate training and supervision is in place to ensure investment advisers understand the features, risks and costs of a complex financial product and consider alternatives.

Dual registrants

- Dual registrants should make clear to the client whether they are acting in the capacity as an investment adviser or broker-dealer when providing investment advice. However, the staff noted that disclosure of capacity may not be determinative if the facts and circumstances suggest that a financial professional is acting in a different capacity.
- Investment advisers who are also registered as broker dealers must consider whether an advisory account or a brokerage account is more appropriate for an investment or investment strategy when providing recommendations or advice to a retail investor. This should take into account differences between the two account types, including reasonably expected total costs over the lifetime of the investment or investment strategy.

SEC Director Birdthistle delivers remarks regarding recent developments in the asset management industry

On March 20, 2023, William Birdthistle, Director of the Division of Investment Management (the Division) of the U.S. Securities and Exchange Commission (the SEC), delivered remarks at the ICI Investment Management Conference, emphasizing that recent technological advancements in the asset management industry, demographic changes in the

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United States and abroad and rapid market growth may present new challenges to advisers' obligations under securities laws.

Technological Advancements and Cybersecurity:

Director Birdthistle noted that the Division is devoting increased attention to examining asset managers' responsibilities in light of recent technological developments, with a view to the following areas:

- *Enhanced Reporting of Cybersecurity and Data Privacy Incidents:* Director Birdthistle suggested that last year's proposed rules and amendments under the Investment Advisers Act of 1940 (the Advisers Act) with respect to cybersecurity risk management and cybersecurity-related disclosure for registered investment advisers (RIAs) and funds could "serve as a significant step" toward addressing new technology-related challenges facing the asset management industry. In particular, he highlighted that the proposed rules and amendments would require RIAs and funds to take steps to mitigate and disclose cybersecurity risks, to enhance adviser and fund disclosures of cybersecurity incidents and to report significant cybersecurity incidents to the SEC.
- *Proposed Amendments to Regulation S-P:* Director Birdthistle also added that the SEC's March 15, 2023 proposal to amend Regulation S-P is designed to minimize risks of unauthorized access to or use of personal information. In particular, he suggested that the proposal, if adopted, would respond to these threats by requiring broker-dealers, RIAs and registered investment companies to adopt written policies and procedures for incident response programs that address unauthorized access to or use of customer information, and include procedures for notifying persons affected by such an incident within 30 days.
- *Proposed Amendments to the Investment Adviser Custody Rule:* Director Birdthistle also commented that recent technological developments, including the use of blockchain technologies to record ownership and transfer assets, prompted the SEC's February 15, 2023 proposal to amend the custody rule under the Advisers Act.

Demographic Changes:

Director Birdthistle also noted that changing demographics in the United States and abroad, including the expected wave of retirements in the near future and changing demographic trends within the asset management industry itself, may warrant the Division's focus to ensure that investors receive the "highest quality disclosure available" to make informed investment decisions. Director Birdthistle highlighted the SEC's response to these impending demographic changes in the following areas:

- *Annual and Semi-Annual Shareholder Reports Provided (Mutual Funds and ETFs):* Director Birdthistle cited the SEC's adoption in October 2022 of amendments to the requirements for annual and semi-annual shareholder reports provided by mutual funds and exchange-traded funds (ETFs). In particular, he emphasized that these reports will now be significantly shorter, will highlight key information and will facilitate comparisons among different products.

- *Proposed Amendments to the Names Rule under the Investment Company Act of 1940 (the Names Rule)*: Director Birdthistle noted that the SEC's proposed amendments to the Names Rule are designed to address the evolution of naming practices in the fund industry. In particular, to enhance alignment between the marketing benefits associated with a particular fund name and investors' expectations, Director Birdthistle highlighted that the proposed amendments would extend the 80% investment policy requirement to "any fund name with terms suggesting that the fund focuses in investments that have (or whose issuers have) particular characteristics."
- *Diversity Self-Assessments:* Director Birdthistle noted that the response rate to SEC's Office of Minority and Women Inclusion's request for voluntary self-assessments of investment advisers' diversity policies and practices was "disappointingly low." Relatedly, he cited the Division's recent publication of a Staff FAQ on investment adviser consideration of DEI Factors, which explained that an investment adviser may consider DEI factors when recommending other investment advisers to, or selecting other investment advisers for, its clients under its fiduciary duty.

Rapid Market Growth:

Director Birdthistle also noted that the rapid growth in the market overall and the number and type of underlying products may present new challenges for investment advisers and the funds that they manage. He added that increasing competitive pressures in the asset management industry may encourage advisers to seek cost efficiencies, including:

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– *Outsourcing Advisory Services to Third-Party Service Providers*: Director Birdthistle expressed concern over investment advisers outsourcing advisory services to, or sharing investors' personal information with, third-party service providers without adequate oversight or disclosures to investors. Specifically, he identified a heightened risk of client harm when, without appropriate regulatory oversight, an adviser outsources functions to service providers that are highly technical, proprietary to the service provider or otherwise necessary to its provision of advisory services. Director Birdthistle described the proposed new Rule 206(4)-11 and related amendments under the Advisers Act (the Proposed Outsourcing Rule) as responsive to this trend. The Proposed Outsourcing Rule would require RIAs to conduct due diligence of third-party service providers and impose ongoing monitoring obligations on them, which Director Birdthistle characterizes as furthering investor protections by enhancing RIAs' oversight of such service providers.

Litigation

SEC sues adviser and principals for liquidity rule violations, settles related actions with former principal

On May 5, 2023, the SEC filed a civil complaint (the Complaint) against Pinnacle Advisors, LLC, (Pinnacle) an East Syracuse-based adviser, and its president, its CEO/CCO, and two independent trustees of the NYSA Fund (the Fund) an open-end registered investment company managed by Pinnacle, for aiding and abetting violations of the "liquidity rule" under the Investment Company Act. The suit is captioned *SEC v. Pinnacle Advisors, LLC et al.*, 5:23-CV-547, and is pending in the U.S. District Court for the Northern District of New York.

The Liquidity Rule, rule 22e-4 under the Investment Company Act of 1940, generally requires open-end funds to manage liquidity risk by establishing a liquidity risk management program, by not investing more than 15% of their assets in illiquid investments, and by disclosing breaches of that limit through a confidential filing with the Commission.

The Complaint alleges that the Fund held 21-26% of its net assets in illiquid investments. The majority of this amount was held in shares of a private medical device company. According to the Complaint, from 2017 to 2019, the Fund's counsel advised Pinnacle and the individual defendants regarding the requirements of the liquidity rule, and expressed concerns that the Fund's shares in the medical device company constituted an illiquid investment. As the June 1, 2019 deadline for the Fund to determine whether the shares constituted an "illiquid investment" approached, the Fund's counsel advised that the investment constituted an "illiquid investment."

The Complaint alleges that the individual defendants and Pinnacle determined, on June 10, 2019, to classify the investment in company shares as a "less liquid" investment. Under the Liquidity Rule, a "less liquid" investment is one that can be sold or disposed of in seven calendar days or less, but for which the sale can be expected to settle in more than seven calendar days. It is alleged that Pinnacle represented to the SEC that it had determined that the company shares could be sold in seven calendar days or less based on recent sales of company shares, investor interest in the shares, and positive news that the company would be closing a significant transaction. The SEC alleges that these representations were false because, among other reasons, the shares were unregistered, subject to transfer restrictions such as a right of first refusal, and the company had not sold any shares for nearly a year.

Upon learning of the Fund's position that the shares should be classified as a "less liquid investment," the Fund's counsel resigned; the Fund's auditors later resigned, allegedly due to concerns about the fund's valuation of illiquid securities such as the company shares. In June 2020, the Fund disclosed to the SEC that the company shares were "illiquid investments" and that the Fund was in breach of the Liquidity Rule; the Fund was subsequently placed into liquidation in August 2020; the company shares allegedly have not been sold.

In a separate action, also released on May 5, 2023, the SEC instituted and settled cease-and-desist proceedings against a third trustee of the Fund, who had previously served as the CEO of an affiliate of Pinnacle Advisors, for allegedly causing the Fund's violations of the Liquidity Rule; the trustee agreed to cease and desist from future violations, to pay a civil money penalty of $20,000, and to a six-month suspension from association with or employment by any investment adviser, broker, dealer, municipal securities deal, municipal advisor, transfer agent or ratings agency.

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The SEC has described the Complaint as the “first-ever case enforcing the Liquidity Rule.” While the quantum of assets at stake in this matter is relatively low (the Fund’s NAV is alleged to have been around $1.89 million in the relevant period), this litigation may generate helpful guidance regarding application of the Liquidity Rule, and standards of diligence concerning appropriate classification of investments under the liquidity rule.

SEC charges adviser and principal for breaches of fiduciary duty relating to investment of client funds in leveraged ETFs

On May 4, 2023, the SEC issued an order (the CAM Order) instituting and settling cease-and-desist proceedings against Classic Asset Management LLC (Classic), a North Dakota-based adviser, and its part-owner, Douglas Schmitz, arising out of alleged breaches of fiduciary duty relating to investments in leveraged ETFs.

According to the CAM Order, from January 2017 through December 2020, Classic and Schmitz purchased and held leveraged ETFs in advisory client accounts. The Order notes that the prospectus for such leveraged ETFs warned that those funds’ returns for periods longer than a single day will likely differ in amount and direction from the funds’ stated index for the same period, and that, for periods longer than a single day, the fund would lose money if the relevant index’s performance was flat, and possibly even if the index rises.

Despite these warnings, the SEC alleges, Classic and Schmitz invested roughly 76% of the clients Schmitz advised in leveraged ETFs, and that leveraged ETFs comprised roughly 56% of the total market value in client accounts he advised as of December 31, 2019. These client accounts also allegedly held positions in leveraged ETFs for extended periods—90% were alleged to be held for more than 100 days. These accounts experienced substantial losses, allegedly on account of the holdings in leveraged ETFs.

The SEC further alleges that neither Schmitz nor Classic “had a reasonable basis” to conclude that leveraged ETFs were suitable for their clients; Schmitz and Classic also allegedly failed to monitor these investments.

On account of these violations, Schmitz and Classic are alleged to have violated Section 206(2) of the Advisers Act, and Classic is alleged to have violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, which require advisers to adopt and implement procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder.

Schmitz and Classic agreed to cease and desist from future violations, and to be censured. Classic agreed to pay disgorgement of $81,824, prejudgment interest of $13,404, and a civil money penalty of $100,000; Schmitz agreed to pay disgorgement of $523,086, prejudgment interest of $115,027, and a civil money penalty of $100,000.

In connection with the CAM Order, Commissioners Crenshaw and Lizárraga issued a statement noting that “[t]his misconduct serves as an important reminder that complex exchange-traded products pose complex risks” and that “previous Commissions have been highlighting these investor protection issues for some time now.” They further opined that “[c]omplex products, such as leveraged or inverse products that are designed primarily as short-term trading tools for sophisticated investors are unlikely to be in the best interest of a retail investor absent an identified, short-term, investor-specific trading objective.”

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