

Investment Management & Funds Regulatory Update - August 2023

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In this issue, we discuss newly adopted rules and amendments relating to money market fund reforms and regulation of private fund advisers, and recent enforcement actions involving advisers and a fund administrator.

Table of Contents

- [Rules and regulations](#)
 - [SEC adopts money market fund reforms and amendments to Form PF reporting requirements for large liquidity fund advisers](#)
 - [SEC adopts new rules and amendments that increase regulation of private fund advisers](#)
- [Litigation](#)
 - [SEC settles with ETF adviser and its principal for allegedly undisclosed conflicts of interest arising out of securities lenders' agreements to provide financing to adviser and principal](#)
 - [SEC settles with fund administrator for allegedly being a cause of an adviser's fraudulent scheme and Advisers Act violations](#)
 - [SEC settles with fintech adviser for allegedly misleading statements regarding hypothetical performance and use of "hedge clauses," other alleged compliance failures](#)

Rules and regulations

SEC adopts money market fund reforms and amendments to Form PF reporting requirements for large liquidity fund advisers

On July 12, 2023, the U.S. Securities and Exchange Commission (the SEC) [adopted amendments](#) (the Amendments) to certain rules governing money market funds (MMFs) under the Investment Company Act of 1940. The SEC designed the Amendments to improve the resilience of MMFs after a period of significant and rapid investor redemptions at the onset of the COVID-19 pandemic. In a [statement](#) delivered on July 12, 2023, before the SEC's 3-2 vote to adopt the Amendments, SEC Chair Gary Gensler highlighted the risk of investor runs in money market and open-end funds, citing investors' "dash for cash" and dilutive pressures as placing stress on public institutional prime and institutional tax-exempt MMFs. The primary elements of the Amendments include:

- Increasing MMFs' minimum liquidity requirements to 25% daily liquid assets and 50% weekly liquid assets;

- Preventing MMFs from temporarily halting redemptions (so-called “gates”);
- Requiring institutional prime and tax-exempt MMFs to impose liquidity fees during periods of market stress;
- Permitting retail and government MMFs, subject to board determinations and investor disclosures, to manage negative interest rate environments by adjusting the price and number of outstanding shares; and
- Revising certain reporting requirements related to the monitoring of MMF data, including amendments to Form PF with respect to information that large liquidity fund advisers must report for the private liquidity funds they advise.

Notably, the Amendments did not include certain elements included in the December 15, 2021 [proposing release](#), such as mandatory swing pricing for institutional prime and institutional tax-exempt MMFs during periods of daily net redemptions (Swing Pricing). Described by numerous commenters as potentially costly and difficult to implement, Swing Pricing would have required stable net asset value (NAV) MMFs with net redemptions for a particular “pricing period” to adjust their current NAV by a swing factor reflecting spread, transaction and market impact costs. As discussed further below, the SEC replaced Swing Pricing with a mandatory liquidity fee framework, which the SEC believes will “better allocate liquidity costs associated with redemptions to the redeeming investors.”

As outlined above, the primary elements of the Amendments include:

– **Increasing the minimum daily and weekly portfolio liquidity requirements**

- The Amendments increase the liquid asset requirement for MMFs from 10% to 25% of an MMF's total assets in daily liquid assets and from 30% to 50% of its total assets in weekly liquid assets.
 - The SEC intends that the increased daily and weekly liquidity requirements will provide a more substantial buffer to help MMFs manage significant and rapid redemptions during periods of market stress and/or prolonged redemption pressure, while maintaining the flexibility to invest in diverse assets during normal market conditions.
- The Amendments preserve the current approach regarding the consequences of falling below the minimum daily and weekly liquidity requirements. Specifically, if an MMF fails to meet the increased daily and weekly liquidity requirements, it cannot acquire any assets other than daily liquid assets or weekly liquid assets until the minimum thresholds are met.
- The Amendments also update the periodic stress testing requirements to reflect the amendments to the liquidity fee framework (summarized below) and the increased regulatory liquidity minimums. Instead of a generally applicable bright-line threshold, the Amendments permit each MMF to determine the level of liquidity that it considers sufficient for purposes of the rule's stress testing requirements. According to the adopting release, each MMF will need to (i) determine the minimum level of liquidity it seeks to maintain during stress periods, (ii) identify that liquidity level in its written stress testing procedures, (iii) periodically test its ability to maintain such liquidity and (iv) provide the board of the MMF with a report on the results of the testing.

– **Removing temporary redemption gates and the regulatory tie between weekly liquid asset threshold and liquidity fees**

- The Amendments remove the ability of MMFs under Rule 2a-7 to temporarily suspend redemptions (i.e., impose a “gate”). Redemption gates were intended to mitigate the effects of destabilizing preemptive investor redemption behavior during periods of market stress, preserve liquidity and allocate the costs of providing liquidity to redeeming investors. The SEC believes that removing gate provisions will decrease the risk of investor uncertainty and investor runs on MMFs during periods of market stress.
 - MMFs will continue to be able to impose permanent gates to facilitate an orderly liquidation of a fund pursuant to rule 22e-3.
- The Amendments largely retain the discretionary liquidity fee provisions in rule 2a-7, but such fees are no longer tied to a weekly liquid asset threshold. Under the amended rule, irrespective of its weekly liquid asset levels or redemption levels, a non-governmental MMF may impose a liquidity fee of up to 2% of the value of the shares redeemed if the majority of its board (or delegate) determines that such fee would be in the best interest of the MMF.
 - The SEC believes that the amended discretionary liquidity fee provision, without the regulatory tie, will lower the likelihood of sophisticated investors predicting when a fee will be imposed. This may, in turn, reduce the potential for a run or other adverse effects.

– **Imposing a mandatory liquidity fee during periods of market stress**

- As discussed above, the Amendments did not adopt Swing Pricing for institutional prime and institutional tax-exempt MMFs when such MMFs experience daily net redemptions. Instead, the SEC adopted a mandatory liquidity fee to address shareholder dilution and the prospect of a first-mover advantage for institutional MMFs.
 - Under the Amendments, all redeeming investors in institutional prime and institutional tax-exempt MMFs will be charged a mandatory liquidity fee when daily net redemptions exceed 5% of the MMF's net assets, unless such MMF's liquidity costs are *de minimis* (i.e., less than one basis point).
 - The mandatory liquidity fee amount is based on an MMF manager's "good faith estimate," supported by data, of the liquidity costs the MMF would incur if it sold a *pro rata* amount of each security in its portfolio to satisfy the amount of net redemptions. The manager would include the hypothetical costs associated with that sale, including (1) spreads and other transaction costs and (2) market impact factors.
 - If the costs of selling a *pro rata* amount of each portfolio security cannot be estimated in "good faith" and supported by data, then a default liquidity fee of 1% of the value of shares redeemed will apply.
 - The boards of MMFs are responsible for administering the mandatory liquidity fee under the Amendments, but they may delegate this responsibility to the MMF's manager or officers, subject to written guidelines established and reviewed by the board and ongoing board oversight. In connection with any such delegation, MMF boards must "adopt and periodically review written guidelines (including guidelines for determining the application and size of liquidity fees) and procedures under which a delegate makes liquidity fee determinations" and periodically review the delegate's liquidity fee determinations.
 - The SEC believes that the delegation provision will give MMFs greater flexibility to address liquidity fee determinations during periods of market stress. The final rule notes that, in such conditions, it may not be practical to assemble a quorum of the necessary directors in advance of the required application of a fee, particularly because the Amendments require fees to be applied to redemptions on the same day that the 5% net redemption threshold is crossed.
- **Permitting retail and government MMFs to manage potential negative interest rates**
- The Amendments permit retail and government MMFs, subject to board determinations and investor disclosures, to manage negative interest rate environments. Under the Amendments, government and retail MMFs seeking to maintain stable NAVs (stable NAV funds) may either (i) convert from a stable share price to a floating share price or (ii) reduce the number of outstanding shares to maintain a stable NAV per share. If a stable NAV fund converts to a floating NAV under these circumstances, its losses will be reflected through a declining share price. If a stable NAV fund uses a share cancellation mechanism, it will maintain a stable share price, despite losing value, by reducing the number of its outstanding shares.
 - A stable NAV fund may only use a share cancellation mechanism if the fund has negative gross yield as a result of negative interest rates (negative interest rate event) and its board determines that reducing the number of the fund's shares outstanding is in the best interest of the fund and its shareholders. Before it relies upon a share cancellation mechanism, a stable NAV fund must also provide timely, concise and plain-English disclosure to investors about any such share cancellation practices and their effects on investors both before and during a negative interest rate event. Any such disclosure must include:
 - Advance notification to investors in the stable NAV fund's prospectus that the fund plans to use share cancellation in a negative interest rate event and the potential effects on investors; and
 - When the fund is cancelling shares, information in each account statement or in a separate writing accompanying each account statement identifying that such practice is in use and explaining its effects on investors.
- **Imposing certain reporting requirements and amending Form PF**
- To improve transparency and enhance the SEC's ability to monitor MMF data, the Amendments impose new reporting requirements regarding the composition and concentration of MMF shareholders and prime funds' sales of non-maturing investments. MMFs will also be required to report information about their application of liquidity fees and their use of share cancellation mechanisms in negative interest rate environments.
 - The Amendments also amend Form PF with respect to the information that large liquidity fund advisers (i.e., advisers with at least \$1 billion in combined liquidity fund and MMF assets) must report for the private liquidity funds that they advise.

The Amendments will be effective 60 days after publication in the Federal Register, and the reporting form amendments will be effective on June 11, 2024. The SEC provided for a six-month transition period for compliance with certain amendments, including the minimum portfolio liquidity requirements and discretionary liquidity fee provision, and 12 months for compliance with the mandatory liquidity fee provision.

SEC adopts new rules and amendments that increase regulation of private fund advisers

On August 23, 2023, the SEC voted to adopt long-awaited new rules and amendments under the Investment Advisers Act of 1940 (Advisers Act). The SEC noted that the amendments are designed in part to increase investors' visibility into certain adviser practices, and to address adviser practices that can potentially lead to investor harm. As adopted, the new rules and amendments significantly increase regulatory compliance obligations of private fund advisers. The SEC's amendments include new requirements related to quarterly statements, private fund audits, adviser-led secondaries, restricted activities, preferential treatment and annual reviews under Rule 206(4)-7. For further information, please see our prior [client update](#).

Litigation

SEC settles with ETF adviser and its principal for allegedly undisclosed conflicts of interest arising out of securities lenders' agreements to provide financing to adviser and principal

On August 1, 2023, the SEC issued an [order](#) (the ETFGMG Order) instituting and settling cease-and-desist proceedings against ETF Managers Group LLC (ETFMG) and parent company, Exchange Traded Managers Group LLC (together ETFMG, the Advisers) and its principal and founder, Samuel Masucci (Masucci). The Advisers allegedly caused an ETF that ETFMG advised, ETFMG Alternative Harvest ETF (MJ), to continue a less advantageous securities lending relationship for the purpose of obtaining \$20 million in rescue financing for themselves from the ETF's securities lender.

MJ is an ETF that tracks an index of companies "involved in the business of growing, marketing and selling cannabis products for medical and recreational use." According to the Order, in September 2018, Advisers moved MJ's custody and securities lending to Company A, a broker-dealer, because a number of banks declined to do business with a cannabis-focused ETF at that time. By 2019, the SEC alleges, the number of willing service providers for cannabis funds had increased. In the spring and summer of 2019, Advisers received "more than a half-dozen" alternatives to Company A; Masucci was advised that securities lending providers with more favorable revenue splits would provide "tens of millions of dollars" of additional annual revenue as compared to maintaining MJ's securities lending business with Company A.

In May 2019, Advisers learned that they had lost a trial that would potentially impose liabilities in the tens of millions of dollars, threatening Advisers with insolvency and the loss of ETFMG's advisory contracts. The same case also exposed Masucci to potential personal liability. Masucci allegedly began to solicit offers to finance the potential liability; by August 2019, Company A offered to finance and guarantee an offer to settle the litigation. Initial drafts of the financing arrangement expressly required that MJ retain its securities lending business at Company A; that term was deleted in a final draft, but a side agreement also provided that Company A would provide free investment banking services estimated to be worth \$4 million to Masucci and Advisers in exchange for keeping MJ's business at Company A. Masucci allegedly directed an executive of Advisers to cease searching for alternative securities lenders to replace Company A, and cut off further communications with such alternatives.

Masucci informed MJ's independent trustees about terms in the final documentation with Company A, but allegedly did not inform them of the condition to keep MJ's securities lending business at Company A or otherwise inform the trustees of the connection between financing arrangements and retaining MJ's securities lending business at Company A. The SEC further alleges that Masucci did not disclose the existence of alternative offers to Company A, and the more favorable terms of those offers. According to the ETFMG Order, this conduct breached both the fiduciary duties of care and loyalty owed to MJ by ETFMG and Masucci.

On account of the conduct alleged, the SEC asserts that Masucci and ETFMG willfully violated Sections 206(1) and 206(2) of the Advisers Act. Masucci, ETFMG and parent company, Exchange Traded Managers Group LLC, were charged with willfully violating Sections 17(d) and 17(d)-1 of the Investment Company Act. Masucci agreed to cease and desist, pay a penalty of \$400,000, to an associational bar under the Advisers Act and a prohibition under the Investment

Company Act with a right to reapply after three years. ETFMG and Exchange Traded Managers Group LLC agreed to cease and desist from future violations, to be censured, and to pay, jointly and severally, a civil penalty of \$4 million.

SEC settles with fund administrator for allegedly being a cause of an adviser's fraudulent scheme and Advisers Act violations

On August 7, 2023, the SEC issued an [order](#) (the TFS Order) instituting and settling cease-and-desist proceedings against a fund administrator, Theorem Fund Services LLC (TFS), for allegedly failing to inquire about the existence and propriety of accounting for a supposed receivable from a fund's adviser, which offset the fund's trading losses, thereby allowing the adviser to overstate the fund's net asset value and obscure an alleged scheme to defraud fund investors.

According to the order, TFS provided administration services to a fund (the Fund) managed by EIA All Weather Alpha Fund Partners (EIA) and its sole owner, Andrew M. Middlebrooks (Middlebrooks).

As fund administrator, TFS was responsible for calculating the Fund's performance, including calculating the Fund's monthly NAV and gross profits to investors, and creating investor statements. The TFS Order states that TFS had "minimal policies and procedures" regarding a number of its responsibilities, including onboarding new clients and calculating a fund's NAV. TFS's administration relationship with EIA was governed by an administration agreement, but TFS allegedly failed to enforce a number of requirements of the administration agreement.

In its initial onboarding of EIA, TFS allegedly failed to respond to a number of red flags, including the fact that EIA did not perform its obligation to appoint an independent auditor, and did not provide TFS with account access to any bank accounts or brokerage accounts. According to the TFS Order, certain brokerage statements that EIA did provide to TIA showed that EIA had incurred trading losses from September to December 2017 totaling over \$300,000 of the fund's approximately \$400,000 in assets.

In February and March 2018, trading statements provided to TFS showed that EIA had sustained additional losses of around \$342,000. Middlebrooks and EIA directed TFS to record an "expense reimbursement" due from EIA to the Fund for all trading losses, which offset the effects of the loss and resulted in no decline to the Fund's NAV. TFS allegedly further agreed to treat any additional trading losses as an increase in this receivable. The SEC alleges that EIA never assumed any legal obligation to reimburse the Fund for the losses, and that TFS never verified that any legal obligation existed, the collectability of the purported receivable, or whether this arrangement was appropriate.

As a result of these instructions, the Fund's trading losses were offset by the receivable, and reflected in the NAV that TFS calculated and that was used to create investor statements and fact sheets for the Fund. During this period, TFS also prepared "account level" fact sheets that did show the trading losses as a reduction to NAV, not offset by the purported receivable. This discrepancy allegedly showed the impact of the receivable: the fund's performance since inception through July 2018 including the receivable was positive 148.39%, whereas performance not including the receivable was negative 63.9%.

The TFS Order states that in January 2019, TFS recommended to EIA and Middlebrooks that they disclose to investors that the Fund had incurred trading losses and that the Fund had recorded those trading losses as a receivable. EIA and Middlebrooks never made the disclosures. In February 2019, TFS terminated the Administration Agreement based on EIA's breaches of the conditions of the agreement. However, TFS continued to provide fund administration services for the Fund through May 2019.

In 2022, the SEC brought a civil action against Middlebrooks and EIA in the U.S. District Court for the Eastern District of Michigan, for allegedly misappropriating and misusing investor's funds over a five-year period.

The SEC alleges that TFS's failure "was a cause of EIA's and Middlebrooks' violations of Section 206(4) of the Advisers Act and Rule 206(4)-8(a)(1) thereunder and Sections 17(a)(2) and 17(a)(3) of the Securities Act." TFS agreed to cease and desist from further violations, to pay a civil penalty of \$100,000, and to pay disgorgement of \$18,000 and prejudgment interest of \$4,271.

SEC settles with fintech adviser for allegedly misleading statements regarding hypothetical performance and use of "hedge clauses," other alleged compliance failures

On August 21, 2023, the SEC issued an [order](#) (the Titan Order) instituting and settling cease-and-desist proceedings against Titan Global Capital Management USA LLC (Titan Global), a New York-based investment adviser that made

strategies available to investors solely through a mobile app. The SEC alleges that Titan Global made misleading advertisements regarding hypothetical returns generated from its investment strategies, and that its advisory agreements contained disclaimers that falsely suggested clients had waived non-waivable causes of action under state and federal laws.

According to the Titan Order, from August 2021 through October 2022, Titan Global offered its investment strategies to retail investors through a mobile app. Under certain amendments to Advisers Act Rule 206(4)-1 (Marketing Rule) adopted in 2020, Titan Global could not advertise hypothetical performance information unless it adopted and implemented policies and procedures designed to ensure that hypothetical performance was relevant to the targeted investors, provided sufficient information to the intended audience, and such hypothetical performance information is not misleading.

The SEC alleges that Titan failed to adopt and implement adequate policies and procedures regarding the use of hypothetical performance results, and thus, used results that did not comply with the Marketing Rule. The SEC also alleges that Titan Global published hypothetical performance results that were materially misleading. For example, the Titan Order states that Titan Global advertised an “annualized return” of 2,700% for the Titan Crypto strategy, but did not disclose that the hypothetical return was generated by extrapolating hypothetical performance in a hypothetical account from a three-week period in August 2021. According to the Titan Order, additional information on the assumptions Titan Global used to calculate the hypothetical annualized return was not provided in the advertisement, but was instead only accessible through links in the advertisement.

The SEC also alleges that Titan Global made misleading disclosures regarding the custody of Titan Global crypto assets. Certain disclosure stated that crypto assets would be held by a clearing firm and its affiliate, while other disclosures stated that the clearing firm’s affiliate did not custody crypto assets, and the actual custodian was not disclosed. Other compliance failures alleged in the Titan Order include distributing an advisory agreement that the SEC stated “may mislead” clients into believing they could not exercise legal rights against Titan Global, failing to adopt and implement policies and procedures to prevent the unauthorized application of client signatures to documents, and failing to adopt and implement policies and procedures regarding its representatives’ personal trading in crypto assets.

The Titan Order notes that Titan Global had engaged in voluntary remedial measures since July 2022, including hiring a new Chief Compliance Officer and Chief Legal Counsel, and other steps to strengthen its compliance program, and that Titan Global’s compliance measures had resulted in the discovery of the unauthorized application of client signatures and Titan Global’s self-reporting and remediation of that issue.

On account of the alleged conduct, the SEC alleges that Titan Global violated Sections 206(2) and 206(4) of the Advisers Act, and Rules 206(4)-1 and 206(4)-7 thereunder. Titan Global agreed to pay disgorgement of \$192,454, prejudgment interest of \$7,598, and a civil money penalty of \$850,000.

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