Investment Services Regulatory Update

March 2024

Monthly Version

VedderPrice

New Rules, Proposed Rules, Guidance and Alerts

NEW AND PROPOSED RULES

SEC and CFTC Adopt Amendments to Form PF for Private Fund Reporting

On February 8, 2024, the SEC and the Commodity Futures Trading Commission (CFTC) jointly adopted amendments to Form PF, a form that requires registered investment advisers to private funds to confidentially report certain information about the funds' operations and investment strategies. An adviser is required to file Form PF if the adviser is registered with the SEC, manages one or more private funds and has at least $150 million in private fund assets under management. The amendments are designed to enhance the Financial Stability Oversight Council's risk monitoring capabilities as well as the SEC's and CFTC's regulatory oversight and investor protection efforts in the private fund industry.

The amendments to Form PF are the third set of amendments to the Form adopted in the past year, with amendments adopted in May 2023[1] and July 2023.[2] The February 2024 amendments to Form PF include the following:

Reporting Complex Structures

- Form PF currently allows an adviser to report master-feeder arrangements and parallel fund structures in the aggregate or separately, as long as the reporting is done consistently throughout the Form. The amendments will require advisers to report each component of a master-feeder arrangement and parallel fund structure separately in most situations.
- In addition, advisers will no longer be able to separately report parallel managed accounts (distinguished from a "parallel fund structure"). Parallel managed accounts are accounts or other pool of assets managed by the adviser that have substantially the same investment objective and strategy and invest side by side in substantially the same positions as the private fund. Instead, advisers must aggregate these parallel managed accounts with the largest private fund to which it relates.

Reporting Funds of Funds

- To improve the consistency of reporting on fund of funds arrangements, the amendments will require an adviser to include the value of investments in other private funds in determining (1) whether the adviser is required to file Form PF, (2) whether it meets thresholds for reporting as a large hedge fund adviser, large liquidity fund adviser or large private equity fund adviser and (3) whether a hedge fund is a qualifying hedge fund. An adviser will also be required to include the value of such investments for purposes of responding to questions on the Form. Currently, Form PF generally permits an adviser to exclude the value of such investments for purposes of the Form's reporting thresholds and in responding to questions on the Form, as long as the reporting is done consistently throughout the Form.

Reporting Trading Vehicles

- Currently, Form PF does not require advisers to identify separate legal entities wholly or partially owned by private funds and used for various purposes, such as for jurisdictional, tax, or other regulatory purposes or to "ring-fence" certain assets for liability reasons (each, a "trading vehicle"). The amendments will require advisers to identify trading vehicles of a reporting fund and report on an aggregated basis for the reporting fund and such trading vehicles, as well as provide information related to a trading vehicle's use, position size and risk exposure.

Reporting Timelines

- As proposed, the amendments will require all quarterly filers to file Form PF on a calendar quarter basis, rather than on the current fiscal quarter basis.

[1] The May 2023 amendments included (1) new quarterly event reporting requirements for advisers to private equity funds, (2) enhanced reporting requirements for large private equity fund advisers and (3) new current reporting requirements for large hedge fund advisers. Attorneys in Vedder Price's Investment Services group previously published an article on the May 2023 amendments, available here.

[2] The July 2023 amendments were adopted in conjunction with recent amendments to the regulatory framework for money market funds and require advisers to provide additional information regarding the liquidity funds they advise to align with the amended reporting requirements adopted for money market funds. Attorneys in Vedder Price's Investment Services group previously published an article on the July 2023 amendments, available here.

Enhanced Information About Advisers and Private Funds

- Form PF requires advisers to report identifying information about themselves and the funds they manage. The amendments, adopted largely as proposed, will expand the information an adviser provides to include legal entity identifiers, assets under management, explanations of assumptions made in Form PF reporting, fund type, withdrawal and redemption rights, gross asset value and net asset value, inflows and outflows, base currency, borrowings and types of creditors, fair value hierarchy, beneficial ownership and fund performance.

Enhanced Information About Hedge Funds

- The amendments will require advisers to report more detailed information on hedge fund investment strategies, counterparty exposures and trading and clearing mechanisms and will remove certain duplicative questions.

Reporting on Qualifying Hedge Funds Advised by Large Hedge Fund Advisers

- The amendments will remove the requirement for large hedge fund advisers that advise qualifying hedge funds (i.e., those with a net asset value of at least $500 million) to report certain aggregated information about the hedge funds they manage. In addition, the amendments will enhance the information an adviser must provide with respect to the reporting fund's investment exposure, open and large position reporting, borrowing and counterparty exposure and market factor effects.

The amendments will become effective one year after their publication in the Federal Register. The compliance date for the amendments is the same as the effective date.

The adopting release is available here, a related fact sheet is available here and a related press release is available here.

SEC Adopts New Rules Expanding Definition of Dealers Required to Register with the SEC

On February 6, 2024, the SEC adopted new Rules 3a5-4 and 3a44-2 under the Securities Exchange Act of 1934 that further define the phrase "as a part of a regular business" that is used in the definitions of "dealer" and "government securities dealer" in Sections 3(a)(5) and 3(a)(44) of the Exchange Act, respectively.

Under the new rules, any person that engages in a regular pattern of buying and selling securities for its own account that has the effect of providing liquidity to other market participants by either (i) regularly expressing trading interest that is at or near the best available prices on both sides of the market for the same security and that is communicated and represented in a way that makes it accessible to other market participants, or (ii) earning revenue primarily from capturing bid-ask spreads, by buying at the bid and selling at the offer, or from capturing any incentives offered by trading venues to liquidity-supplying trading interest, is engaged in such activity "as a part of a regular business." Accordingly, such person is therefore a "dealer" or "government securities dealer" and required to register with the SEC under Sections 15(a) or 15C of the Exchange Act, as applicable, become a member of a self-regulatory organization (e.g., FINRA) and comply with federal securities laws and regulatory obligations. Persons engaging in buying and selling securities for their own account "as a part of a regular business," as described in the new rules, are exempt from the new rules if they have or control total assets of less than $50 million, are an investment company registered under the Investment Company Act of 1940, or are a central bank, sovereign entity or international financial institution. The new rules do not seek to address all circumstances under which a person may be acting as a dealer or government securities dealer, and the new rules state there is no presumption that a person is not a "dealer" or a "government securities dealer" solely because that person does not engage in the activities as described in the new rules. Additionally, the new rules provide that a person may not evade the requirements to register with the SEC by engaging indirectly in the activities described in the new rules or by disaggregating accounts.

The new Rules 3a5-4 and 3a44-2 will become effective on April 29, 2024. The compliance date for the new Rules will be April 29, 2025. The one-year compliance period only applies to market participants who are engaging in activities covered by the new rules prior to the compliance date, and does not apply to persons whose activities otherwise satisfy the definition of dealer under applicable SEC interpretations and court precedent.

The SEC's adopting release is available here, a related fact sheet is available here and a related press release is available here.

FinCEN Proposes Rule to Address AML Risks to Advisers

On February 13, 2024, the Financial Crimes Enforcement Network (FinCEN) issued a proposed rule that would extend certain anti-money laundering/countering the financing of terrorism (AML/CFT) program requirements to investment advisers registered with the SEC and exempt reporting advisers with the SEC.

On February 26, 2024, attorneys in Vedder Price's Investment Services group published an article regarding the proposed rule. The complete article is available here.

GUIDANCE AND OTHER DEVELOPMENTS

SEC Staff Issues FAQs on Tailored Shareholder Reports

In January 2024, the staff of the SEC's Division of Investment Management issued guidance in the form of frequently asked questions (FAQs) related to the adoption of rule and form amendments for mutual funds and exchange-traded funds to transmit "concise and visually engaging" tailored shareholder reports (the TSR reforms). Highlights of the FAQs are summarized below.

Appropriate Broad-Based Securities Market Index

The TSR reforms require a fund to show its performance against an "appropriate broad-based securities market index," defined as "an index that represents the overall applicable domestic or international equity or debt markets, as appropriate." The SEC's adopting release includes certain general guidance and examples of the types of indexes that would qualify under the revised definition, noting, for instance, that for a fund that invests primarily in the equity securities of a non-U.S. country, an index representing the overall equity market of the non-U.S. country would satisfy the requirement. In contrast, the adopting release stated that a fund that invests primarily in the equity securities of a *subset* of the U.S. market, such as healthcare companies, should show its performance against the overall U.S. equity market, rather than a healthcare-focused index.

In the FAQs, the SEC staff provided the following additional guidance:

- A fixed-income or equity index that pertains to a group of countries (such as Europe or Asia), a group of countries excluding a specific country or countries (such as Asia excluding Japan), or a group of markets with shared characteristics (such as emerging markets or developed markets) would qualify as an appropriate broad-based securities market index.
- Because, in the SEC staff's view, the national municipal securities market may be understood as a standalone overall market, rather than a subset of the fixed income market more broadly, a fund that invests primarily in tax-exempt municipal securities, including a fund that invests primarily in the municipal securities of a single state, may use an index that reflects the national municipal securities market as its broad-based index.

Delivery of Materials for Funds Underlying Variable Annuity or Insurance Contracts

- For funds that are investment options underlying variable annuity or insurance contracts, the requirements of Rule 30e-1 under the Investment Company Act of 1940 to make certain materials available on a website may be satisfied by having the required underlying fund materials appear *either* on the variable contract issuer's website or on the fund's website.
- Where a variable contract issuer delivers an electronic shareholder report of an underlying fund to an investor who has opted into e-delivery, the shareholder report must comply with the hyperlinking requirements of Form N-1A. To the extent that the website address in the hyperlink becomes stale or is otherwise inaccurate, the safe harbor in Rule 30e-1 provides that a fund satisfies its obligations to transmit shareholder reports even if it did not meet the posting requirements of the rule for a temporary period of time, *provided* that the fund (i) has reasonable procedures in place to help ensure that the required materials appear online as required, and (ii) takes prompt action to correct noncompliance with the rule's website availability requirements.
- If an underlying fund has elected to include any of the online tools described in Instruction 8 to Item 27A(a) of Form N-1A—e.g., video or audio messages, mouse-over windows, pop-up definitions or explanations of difficult concepts, chat functionality, and expense calculators—the variable contract issuer does *not* need to deliver a version of the shareholder report that includes these optional online tools.

Binding Individual Shareholder Reports of Multiple Funds

- Where an investor has invested in multiple funds (or in multiple share classes of funds), or a variable contract investor has allocated contract value to multiple underlying funds, the individual shareholder reports of each of these funds (or, as applicable, share classes) may be bound, stapled or stitched together for transmission to the investor. The SEC staff added that a fund generally should consider including a table of contents to any such bound shareholder reports for investors' ease of use.

Permissible Methods of Electronic Delivery

- In addition to sending an email which includes the body of the full tailored shareholder report, a fund may deliver an email, or otherwise electronically transmit a notification to investors, that (1) includes direct links to the shareholder report(s) of the fund(s) and share class(es) that the investor owns or (2) specifies the investor's fund(s) and share class(es) and includes a link directing the investor to a website landing page that includes direct links that are limited to the shareholder report(s) for the fund(s) and share class(es) that the investor owns.

Compliance Date and Form N-CSR Filing

A fund that transmits a shareholder report prior to the compliance date (July 24, 2024) (i.e., not a "tailored" shareholder report) but files Form N-CSR *after* the compliance date must include that shareholder report in its Form N-CSR filing and is not required to include a "tailored" shareholder report.

The full list of the SEC staff's FAQs related to the TSR reforms is available here.

SEC Staff Issues Update to Marketing Rule FAQs

On February 6, 2024, the staff of the SEC's Division of Investment Management issued an update to its frequently asked questions (FAQs) guidance related to the Marketing Rule (Rule 206(4)-1 under the Investment Advisers Act of 1940). The update added a new FAQ related to the calculation and presentation of gross and net performance in an adviser's advertisement, as summarized below.

The Marketing Rule requires that any presentation of a private fund's gross performance in an advertisement must be coupled with an equally prominent presentation of net performance calculated over the same time period and using the same type of return and methodology to facilitate comparison between the gross and net performance.

In the new FAQ, the staff took the position that, under the Marketing Rule, adviser advertisements cannot present a private fund's gross internal rate of return (IRR) calculated without the impact of fund borrowing alongside the fund's net IRR calculated *with* the impact of fund borrowing. The staff noted that such a presentation would also result in IRR calculations across different time periods, with a gross IRR calculation beginning when a fund initially uses borrowings to acquire investments and a net IRR calculation beginning once capital has been called to repay the borrowings. The staff also expressed its view that it would be a violation of certain general prohibitions of the Marketing Rule to present only a fund's net IRR calculated with the impact of fund borrowing without also showing either (1) comparable net IRR calculated without the impact of fund borrowing or (2) appropriate disclosure describing the impact of fund borrowing on the net IRR shown.

The full list of the SEC staff's FAQs related to the Marketing Rule is available here.

SEC Announces Departure of William Birdthistle, Director of the Division of Investment Management, and Names Natasha Vij Greiner as New Director

On February 28, 2024, the SEC announced the departure of William Birdthistle, the Director of the SEC's Division of Investment Management, effective March 8, 2024. Director Birdthistle was appointed in December 2021 and oversaw a number of significant proposed and final rulemakings. The announcement noted that Natasha Vij Greiner, the Deputy Director of the SEC's Division of Examinations, would be named as the new Director of the Division of Investment Management. Deputy Director Greiner has served in various roles at the SEC for over 22 years, including Acting Chief Counsel and Assistant Chief Counsel in the Division of Trading and Markets and Senior Counsel in the Division of Enforcement. She also currently serves as the National Associate Director of the Investment Adviser/Investment Company (IA/IC) examination program and as the

Associate Director of the Home Office IA/IC examination program.

The SEC's press release is available here.

PCAOB Reopens Comment Period for NOCLAR Proposal

On February 26, 2024, the PCAOB reopened the comment period, through March 18, 2024, for its proposal to amend PCAOB auditing standards related to an auditor's responsibility for considering a company's noncompliance with laws and regulations (NOCLAR), announcing that it would host a public virtual roundtable on March 6, 2024 regarding the NOCLAR proposal to obtain additional insight from participants. The NOCLAR proposal, if adopted, would establish specific requirements for a company's auditor to "(i) plan and perform procedures to identify the laws and regulations with which noncompliance could reasonably have a material effect on the financial statements, (ii) assess and respond to risks of material misstatement of the financial statements due to noncompliance with those laws and regulations, and (iii) identify whether there is information indicating that noncompliance with those laws and regulations has or may have occurred."

A significant number of comment letters have been submitted in response to the NOCLAR proposal, with commenters citing concerns regarding the expansion of the scope of audits beyond an audit of historical financial statements and the potential for confusion regarding the appropriate role of auditors, among others. The NOCLAR proposal was issued on June 6, 2023, followed by a 60-day comment period that originally closed on August 7, 2023.

The PCAOB's news release is available here.

Litigation and Enforcement Matters

ENFORCEMENT DEVELOPMENTS

SEC Settles Charges Against Adviser for Alleged Section 15(c) Violations from Failure to Disclose Index License Fee Structure to ETF's Board

On February 16, 2024, the SEC announced that it had settled charges against a registered investment adviser for alleged violations of Section 15(c) of the Investment Company Act of 1940 as well as provisions of the Investment Advisers Act of 1940 and the rules thereunder.

According to the SEC's order, the adviser, which manages ETFs, failed to inform the independent trustees of the ETF board of the terms of the licensing agreement between the adviser and the index provider for a new ETF the adviser proposed to launch. According to the order, the licensing fee was structured so that the adviser would pay the index provider at least 20% of the adviser's net unitary management fee, and as much as 60% of the net management fee if the new ETF exceeded $1.25 billion in assets under management within 18 months of the ETF's launch. The SEC alleged that the sliding scale of the licensing fee was based on the index provider's partnership with a well-known and controversial social media influencer who would promote the ETF's underlying index and receive compensation from the index provider. The SEC alleged that the information the independent trustees received in connection with the adviser's proposed organization and launch of the new ETF disclosed a 20% licensing fee but not the sliding scale under which the licensing fee would increase if the ETF's assets reached certain thresholds. According to the order, the independent trustees were not able to evaluate the adviser's forecasted profitability from managing the ETF or evaluate the extent to which economies of scale would be realized as the ETF grew because they did not have the information needed to consider the economic impact of the sliding scale arrangement. The SEC further alleged that the adviser did not have adequate written policies and procedures about furnishing the ETF's board with accurate information reasonably necessary for the board to evaluate the terms of the advisory agreement.

The SEC found that the adviser willfully violated Section 15(c) of the 1940 Act, which requires a fund's investment adviser to furnish such information as may reasonably be necessary for the fund's directors to evaluate the terms of the fund's advisory agreement; Section 206(2) of the Advisers Act, which makes it unlawful for any adviser to engage in a transaction, practice or course of business that operates as a fraud or deceit upon a current or prospective client; and Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder which require registered investment advisers to adopt and implement written compliance policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder. Without admitting or denying the SEC's findings, the adviser consented to cease and desist from future violations and to censure, and agreed to pay a civil penalty totaling $1.75 million.

The SEC's order is available here. A related press release is available here.

SEC Settles Charges Against Adviser/Broker-Dealer for Alleged Whistleblower Protection Rule Violations

On January 16, 2024, the SEC announced that it had settled charges against a dually registered investment adviser and broker-dealer for allegedly impeding its advisory clients and brokerage customers from reporting potential violations of the federal securities laws to the SEC, in violation of whistleblower protections under the Securities Exchange Act of 1934. The firm agreed to pay a record $18 million civil penalty to settle the charges.

According to the SEC's order, from March 2020 through July 2023, the firm had asked certain clients that had been issued a credit or settlement of more than $1,000 to sign a confidential release agreement, which required the clients to keep the agreement confidential, including the existence and terms of the agreement, the underlying facts and other related information. Although such agreements expressly permitted the clients to respond to SEC inquiries, the terms of the agreements effectively prohibited clients from voluntarily contacting the SEC. The SEC found that the firm had willfully violated Rule 21F-17(a) under the Exchange Act, which prohibits any person from taking action to impede an individual from communicating directly with the SEC staff about possible securities law violations, including enforcing, or threatening to enforce, certain confidentiality agreements with respect to such communications.

In the settlement of the charges, without admitting or denying the findings set forth in the SEC's order, the firm agreed to be censured, to cease and desist from committing or causing violations of Rule 21F-17(a) and to pay an $18 million civil penalty. The $18 million penalty represents the largest civil penalty imposed for standalone whistleblower protection rule violations. The SEC's order also follows two other recent enforcement actions for whistleblower protection rule violations that were settled in September 2023.

The SEC's order is also notable for its application of whistleblower protections to client agreements, as charges for alleged violations of Rule 21F-17(a) have historically been brought in the context of employee agreements. In the press release announcing the settlement, Gurbir Grewal, the Director of the SEC's Division of Enforcement, stated that, "[w]hether it's in your employment contracts, settlement agreements or elsewhere, you simply cannot include provisions that prevent individuals from contacting the SEC with evidence of wrongdoing."

The SEC's order is available here. A related press release is available here.

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Investment Services Group

With significant experience in all matters related to design, organization and distribution of investment products, Vedder Price can assist with all aspects of investment company and investment adviser securities regulations, compliance issues, derivatives and financial product transactions, and ERISA and tax inquiries. Our highly experienced team has extensive knowledge in structural, operational and regulatory areas, coupled with a dedication to quality, responsive and efficient service.

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