Investment Services Regulatory Update

November 2024

Monthly Version

VedderPrice

New Rules, Proposed Rules, Guidance and Alerts

GUIDANCE AND OTHER DEVELOPMENTS

SEC Staff Issues 2025 Examination Priorities

On October 21, 2024, the staff of the SEC's Division of Examinations issued its examination priorities for 2025. The examination priorities are summarized below and include areas of particular interest to regulated entities such as registered investment advisers, registered funds, and broker-dealers. Many examination priorities are relatively unchanged from recent years, including examinations of advisers to private funds, the use and oversight of third-party service providers, cybersecurity and operational resiliency, and the proliferation of crypto assets and emerging financial technologies. Examinations of newly registered advisers and funds, advisers and funds that have never been examined, and those that have not been recently examined are perennial areas of focus, as are examinations regarding compliance with recently adopted SEC rules. New or enhanced examination priorities for 2025 include controls and oversight around the use of artificial intelligence (AI) and accurate disclosure regarding AI capabilities, as well as investments in commercial real estate, illiquid assets, and private credit.

Investment Advisers
Examinations of investment advisers will continue to focus on advisers' adherence to their fiduciary duties of care and loyalty with respect to investment advice and their mitigation and disclosure of conflicts of interest. The SEC staff stated that it remains focused on advisers' compliance programs, with particular focus on marketing, valuation, trading, portfolio management, disclosure and filings, and custody. Examinations may also go into greater depth on illiquid or difficult-to-value assets such as commercial real estate, as well as integration of AI into advisory operations and oversight of independent contractors. Examinations will also focus on advisers to private funds, including disclosure practices and calculating and allocating private fund fees and expenses.

Investment Companies
Examinations of investment companies (e.g., mutual funds and ETFs) will focus on compliance programs, disclosures, and governance practices, with a particular focus on fund fees and expenses (and any associated waivers and reimbursements), oversight of services providers, portfolio management practices and disclosures, and issues associated with market volatility.

Broker-Dealers
The SEC staff stated that it will continue to examine broker-dealer practices related to Regulation Best Interest and recommendations of products that are complex, illiquid, or that present higher risk to investors. Examinations will also review the content, SEC filing, and customer delivery of a broker-dealer's relationship summary on Form CRS. The SEC staff stated that it will focus on broker-dealers' compliance with the net capital rule and the customer protection rule, operational resiliency programs, risk management controls, and trading practices.

Self-Regulatory Organizations, Clearing Agencies and Other Market Participants
The examination priorities also outline focus areas for examinations of (1) self-regulatory organizations, including national securities exchanges, FINRA, and the Municipal Securities Rulemaking Board (MSRB); (2) clearing agencies; and (3) other market participants, including municipal advisors, transfer agents, security-based swap dealers, security-based swap execution facilities, and funding portals.

Risk Areas Impacting Various Market Participants
Lastly, the SEC staff highlighted examination priorities with respect to (1) information security and operational resiliency, including matters such as cybersecurity, compliance with Regulations SID and S-P, and compliance with the shortened T+1 settlement cycle applicable to most securities; (2) AI and emerging financial technologies; (3) crypto assets; (4) Regulation Systems Compliance and Integrity (SCI); and (5) anti-money laundering.

Conclusion
The SEC staff stated that the examination priorities it has highlighted are not a comprehensive compilation of the issues that it will address in examinations, and that it will cover other areas and conduct examinations focused on and devote resources to new or emerging risks, products and services, market events, and investor concerns.

The Division of Examinations' 2025 examination priorities are available here.

Litigation and Enforcement Matters

LITIGATION DEVELOPMENTS

Massachusetts Court Rules in Favor of Closed-End Funds Regarding Majority Rule Bylaw Amendment

On October 21, 2024, a Massachusetts Superior Court ruled in favor of four closed-end funds, holding that the funds' 2020 bylaw amendment that requires trustee nominees in a contested election to receive the affirmative vote of a majority of the fund's outstanding shares in order to be elected does not violate Section 18(i) of the Investment Company Act of 1940, which requires all shares to have equal voting rights, or the funds' declaration of trust, which allows shareholders to elect trustees.

The plaintiff, an activist investor in the closed-end funds, argued that the funds' amended bylaw provisions set a threshold for electing dissident trustees that was too high to achieve in practice and therefore deprived the funds' shareholders of their right to elect trustees. The court rejected the plaintiff's assertion, concluding that increasing the required vote to elect a dissident trustee from a plurality threshold to a majority of the fund's outstanding shares does not disenfranchise shareholders and instead ensures that a dissident trustee candidate has the support of a majority of the fund's shareholders. Regarding the plaintiff's claim that the bylaw amendment violated the Section 18(i) requirement that all shares have equal voting rights, the court held that the amendment did not cause any shareholder votes to be weighted differently from any other shareholder vote.

The order was issued under the caption *Eaton Vance Senior Income Trust v. Saba Capital Master Fund, Ltd.*, Case No. 2084-CV-01533 (Mass. Super. Ct. Oct. 21, 2024).

ENFORCEMENT DEVELOPMENTS

SEC Settles Enforcement Proceedings Against Adviser for Allegedly Misleading Investors Regarding Certain ETFs' ESG-Related Investment Strategies

On October 21, 2024, the SEC announced the settlement of administrative proceedings brought against a registered investment adviser for allegedly making misleading statements regarding how it managed certain ETFs that were marketed as incorporating environment, social and governance (ESG) factors in their investment strategies and for failing to maintain adequate written policies and procedures governing the implementation of its investment process.

According to the order, from March 2020 to November 2022, the adviser represented to the ETFs' board of trustees and in prospectus disclosures that its investment process for the ETFs incorporated certain ESG factors using a model developed by the adviser and that, as part of that investment process, securities of companies with any involvement in fossil fuels, tobacco or certain other activities were screened out. As described in the order, to identify such companies, the adviser's model relied on data sets purchased by the adviser from third-party vendors. The order alleges that, during the relevant period, the adviser was aware that its investment process failed to exclude securities of certain companies involved in fossil fuels or tobacco-related activity due to limitations in the third-party data sets, and that the adviser failed to describe such limitations to the ETFs' board or in the ETFs' prospectuses. According to the order, in response to an examination by the SEC's Division of Examinations, the adviser updated the ETFs' prospectuses in November 2022 to address these limitations and provide additional risk disclosure. The order also alleges that the adviser failed to adopt and implement written policies and procedures in connection with its investment process for the ETFs, including the model's exclusionary screening process.

The SEC found that the adviser willfully violated (1) Section 206(2) of the Investment Advisers Act of 1940, 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; (2) Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder, which make it unlawful for any investment adviser to make any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading to any investor or prospective investor; (3) 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; and (4) Section 34(b) of the Investment Company Act of 1940, which makes it unlawful for any person to make any untrue statement of a material fact in any registration statement and other documents filed or transmitted pursuant to the Investment Company Act, or to omit to state therein any fact necessary in order to prevent the statements made therein, in the light of the circumstances under which they were made, from being materially misleading.

Without admitting or denying the allegations, the adviser agreed to cease and desist from future violations, to be censured and to pay a civil monetary penalty of $4,000,000.

The SEC's order is available here, and a related press release is available here.

SEC Settles Enforcement Proceedings Against Dually Registered Broker-Dealer and Investment Adviser for Alleged Violations of Regulation Best Interest

On October 2, 2024, the SEC announced the settlement of administrative proceedings brought against a dually registered broker-dealer and investment adviser for alleged violations of Rule 15l-1 under the Securities Exchange Act of 1934, known as Regulation Best Interest, related to its use of a mutual fund share class calculator in recommending investments to its retail brokerage customers.

Regulation Best Interest establishes a four-part standard of conduct for broker-dealers and associated persons in making recommendations to retail customers regarding securities transactions and investment strategies involving securities. The four parts consist of (1) the disclosure obligation, (2) the care obligation, (3) the conflict of interest obligation, and (4) the compliance obligation. The settled action involves alleged violations of the care obligation and the compliance obligation. The care obligation requires broker-dealers and associated persons, in making recommendations to retail customers, to understand the potential risks, rewards, and costs associated with the recommendation, and have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers. With respect to specific customers, it also requires having a reasonable basis to believe that the recommendation is in the customer's best interest based on the customer's investment profile, and does not place the broker-dealer's or associated person's interests ahead of the customer's interest. The compliance obligation requires broker-dealers to establish, maintain, and enforce written policies and procedures reasonably designed to achieve compliance with Regulation Best Interest.

According to the SEC order, the broker-dealer and its registered representatives utilized a share class calculator to identify and recommend an appropriate mutual fund share class for retail customers' investment within college savings plans. The Class A shares offered imposed upfront sales charges as well as annual fees, while Class C shares did not impose upfront sales charges but charged higher annual fees than Class A shares. The order alleges that, while investing in Class A shares may have been in the best interest of many of its customers historically, the broker-dealer failed to update its share class calculator to account for changes to the expense structure of Class C shares made in March 2020 and December 2020 that significantly reduced the annual fees charged on Class C shares and made Class C shares less expensive than Class A shares for many of its customers. As a result, between June 30, 2020 and July 2022, the broker-dealer continued to recommend Class A shares to its customers investing in the plans.

The order alleges that because the broker-dealer failed to understand the difference in costs of Class A and Class C shares during the relevant period, the broker-dealer and its registered representatives failed to exercise reasonable

diligence, care, and skill when recommending investments within the plans to its retail customers and did not have a reasonable basis to believe that its recommendations were in the customers' best interest. The order also alleges that because the broker-dealer did not have procedures reasonably designed to ensure that it timely reviewed and updated the costs of share classes in its share class calculator, it violated its compliance obligation to establish, maintain, and enforce written policies and procedures reasonably designed to achieve compliance with Regulation Best Interest. In addition, by failing to comply with Regulation Best Interest's compliance obligations, the order alleges that the broker-dealer willfully violated Regulation Best Interest.

Without admitting or denying the allegations, the broker-dealer agreed to cease and desist from future violations, to be censured, and to pay a civil monetary penalty of $25,000. In the order, the SEC noted its consideration of the broker-dealer's prompt remedial acts and cooperation afforded to the SEC staff.

The SEC order is available here.

Investment Services Group Members

Chicago

John S. Marten, *Co-Chair* ..... +1 (312) 609 7753
James A. Arpaia ..... +1 (312) 609 7618
Deborah B. Eades ..... +1 (312) 609 7661
Renee M. Hardt ..... +1 (312) 609 7616
Randall M. Lending ..... +1 (312) 609 7564
Joseph M. Mannon ..... +1 (312) 609 7883
Maureen A. Miller ..... +1 (312) 609 7699
Cathy G. O'Kelly ..... +1 (312) 609 7657
Mark Quade, *Editor* ..... +1 (312) 609 7515
Nathaniel Segal, *Senior Editor* ..... +1 (312) 609 7747
Jacob C. Tiedt, *Senior Editor* ..... +1 (312) 609 7697
Cody J. Vitello ..... +1 (312) 609 7816
Jeff VonDruska ..... +1 (312) 609 7563
Junaid A. Zubairi ..... +1 (312) 609 7720
Heidemarie Gregoriev ..... +1 (312) 609 7817
Adam S. Goldman ..... +1 (312) 609 7731
Nicholas A. Portillo ..... +1 (312) 609 7665
David W. Soden ..... +1 (312) 609 7793
Christina V. West ..... +1 (312) 609 7567
Jake W. Wiesen, *Editor* ..... +1 (312) 609 7838

Washington, DC

Marguerite C. Bateman, *Co-Chair* ..... +1 (202) 312 3033
Todd F. Lurie ..... +1 (202) 312 3030
Amy Ward Pershkow ..... +1 (202) 312 3360
Bruce A. Rosenblum ..... +1 (202) 312 3379
Kimberly Karcewski Vargo ..... +1 (202) 312 3385
Liz J. Baxter ..... +1 (202) 312 3014
Elisa Cardano Perez ..... +1 (202) 312 3023
Devin Eager ..... +1 (202) 312-3016
Laure Sguario ..... +1 (202) 312 3373

Miami

Christine De Pree ..... +1 (786) 741 3210

Investment Services Group

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