Investment Services Regulatory Update

June 2024

Monthly Version

VedderPrice

New Rules, Proposed Rules, Guidance and Alerts

NEW AND PROPOSED RULES

SEC Adopts Regulation S-P Amendments to Enhance Protection of Customer Information

On May 16, 2024, the SEC adopted amendments to Regulation S-P to enhance and modernize consumer privacy protections in light of technological developments in how individuals' personal information is collected, shared and maintained. Regulation S-P applies to broker-dealers (including funding portals), investment companies, registered investment advisers and transfer agents ("covered institutions") and currently requires (1) covered institutions (excluding transfer agents) to adopt written policies and procedures that address administrative, technical and physical safeguards for the protection of customer records and information (the "safeguards rule"), and (2) covered institutions (including transfer agents) to properly dispose of consumer report information (the "disposal rule"). The amendments are described below.

Scope. The amendments broaden and align the scope of information protected under the safeguards rule and the disposal rule by creating the newly defined term "customer information" to which the protections of both rules apply. The new term provides greater specificity as to the information covered and expands the scope of the disposal rule, which currently only applies to consumer report information. Additionally, transfer agents will now be required to comply with the safeguards rule.

Incident Response Program and Notification Requirements. The amendments enhance the safeguards rule to require covered institutions to adopt a written incident response program that is reasonably designed to detect, respond to and recover from unauthorized access to or use of customer information, including procedures to assess an incident and take appropriate steps to contain and control the incident as well as customer notification procedures. A covered institution will be required to notify individuals whose sensitive customer information was, or is reasonably likely to have been, accessed or used without authorization as soon as reasonably practicable, but not later than 30 days after becoming aware of such actual or likely unauthorized access or use, unless the covered institution determines, after a reasonable investigation, that the sensitive customer information has not been, and is not reasonably likely to be, used in a manner that would result in substantial harm or inconvenience to the affected individual.

Oversight of Service Providers. The amendments to the safeguards rule will also require covered institutions to adopt written policies and procedures reasonably designed to ensure service providers take appropriate measures to protect against unauthorized access to or use of customer information and provide notification to the covered institution as soon as possible, but no later than 72 hours after becoming aware that a breach in security has occurred resulting in unauthorized access to customer information.

Recordkeeping and Annual Notice Amendments. The amendments will require covered institutions (excluding funding portals) to maintain written records documenting compliance with the requirements of the safeguards rule and the disposal rule. Additionally, covered institutions (excluding transfer agents) are currently required to provide customers with annual notices informing them of the institutions' privacy practices. The amendments codify an exception to this annual privacy notice requirement, consistent with the exemption in the Fixing America's Surface Transportation Act (FAST Act).

Compliance Dates. The amendments to Regulation S-P take effect August 2, 2024. Compliance with the amendments is required by February 2, 2026 for larger entities and by August 2, 2026 for smaller entities.

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

SEC and FinCEN Propose Customer Identification Program Requirements for Investment Advisers

On May 13, 2024, the SEC and FinCEN jointly proposed a new rule under the Bank Secrecy Act (BSA) that would impose new customer identification program (CIP) requirements on registered investment advisers and exempt reporting advisers.

The proposed rule is part of a broader effort to strengthen the anti-money laundering/countering the financing of terrorism (AML/CFT) regulatory framework applicable to investment advisers. On February 15, 2024, FinCEN issued a separate proposal to designate registered investment advisers and exempt reporting advisers as "financial institutions" under the BSA and thereby subject them to AML/CFT program requirements and obligations to file suspicious activity reports. In that proposal, FinCEN cited a risk assessment report issued by the Department of the Treasury that identified the investment adviser industry as "an entry point into the U.S. market for illicit proceeds associated with foreign corruption, fraud, and tax evasion."

Under the joint proposed rule, advisers would be required to establish, document and maintain written CIPs as part of their overall AML/CFT programs. Highlights of the joint proposed rule include the following:

- The adviser CIP requirements under the proposed rule are intended to be generally consistent with existing rules applicable to other financial entities, including brokers, dealers and open-end investment companies. Additionally, the proposed rule specifically provides that advisers to mutual funds are not required to include those mutual funds in their CIPs, as mutual funds are already subject to existing CIP requirements.

- The proposed rule would require an adviser's CIP to include procedures for verifying the identity of any person seeking to open an account with the adviser, within a reasonable time before or after the account is opened, with such procedures based on the adviser's assessment of relevant risks (e.g., types of accounts maintained, methods of opening accounts, types of identifying information and the adviser's size, location and customer base). The procedures must specify the identifying information that will be obtained, including, at a minimum, name, date of birth or date of formation, address and identification number. Such procedures must enable the adviser to form a reasonable belief that it knows the customer's true identity. The CIP would also need to include procedures for circumstances in which a customer's identity cannot be verified.

- An adviser's CIP would also be required to include procedures for making and maintaining records related to verifying customer identity, with specified retention periods, as well as procedures for providing customers with adequate notice that the adviser is requesting identifying information.

Comments on the proposal are due on or before July 22, 2024.

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

FINRA Proposes Rules Regarding SEC-Mandated Reporting of Securities Lending Transactions

On May 1, 2024, the Financial Industry Regulatory Authority (FINRA) proposed a new series of rules—FINRA Rule 6500 Series—regarding reporting of securities lending transactions pursuant to the requirements under new Rule 10c-1a under the Securities Exchange Act of 1934 which the SEC adopted on October 13, 2023. Rule 10c-1a requires "covered persons" to report specified information about "covered securities loans" (as these terms are defined in Rule 10c-1a) to FINRA by the end of the day on which a loan is made or modified, in accordance with rules that FINRA is required to adopt by May 2, 2024 and that detail the format and manner by which the loan information is reported. Rule 10c-1a defines a covered person as (1) any person that agrees to a covered securities loan on behalf of a lender (i.e., an intermediary), other than a clearing agency; (2) any person that agrees to a covered securities loan as the lender when an intermediary is not used; or (3) a broker or dealer when borrowing fully paid or excess margin securities. Rule 10c-1a also specifies the securities loan information that FINRA is required to make publicly available and the information it is required to keep confidential.

The proposed FINRA Rule 6500 Series sets forth additional details regarding the format and manner of reporting securities loan information, expands upon the information that must be reported, establishes the Securities Lending and Transparency Engine (SLATE™)—an automated system developed by FINRA that will accommodate the reporting and dissemination of securities loan information, and sets forth how FINRA will report securities loan information required to be made public.

The SEC solicited public comments, which were due on May 28, 2024, on the proposed FINRA Rule 6500 Series, including whether the proposal is consistent with the Exchange Act. The proposed FINRA Rule 6500 Series is required to take effect by January 2, 2025. Covered persons must begin reporting securities lending information required by Rule 10c-1a and the FINRA Rule 6500 Series to FINRA starting on January 2, 2026. FINRA must begin reporting the information required to be made public by April 2, 2026.

The proposed FINRA Rule 6500 Series and the SEC's request for comment are available here. An article published by attorneys in Vedder Price's Investment Services group that summarizes new Rule 10c-1a is available here.

GUIDANCE AND OTHER DEVELOPMENTS

Highlights from 2024 ALI-CLE Accountants' Liability Conference

The annual ALI-CLE Accountants' Liability Conference occurred in Washington, D.C. on May 16 and 17, 2024 and was co-hosted by Junaid A. Zubairi, Chair of Vedder Price's Government Investigations and White Collar Defense group, and Veronica Callahan of Arnold & Porter LLP. The conference featured a wide variety of speakers, including regulators from the SEC and the PCAOB, in-house counsel, outside counsel and consultants.

On May 20, 2024, attorneys in Vedder Price's Government Investigations and White Collar Defense group published an article discussing highlights from the conference, available here.

Litigation and Enforcement Matters

LITIGATION DEVELOPMENTS

Fifth Circuit Vacates Private Fund Adviser Rules

On June 5, 2024, in a 3-0 decision, the Fifth Circuit Court of Appeals vacated the private fund adviser rules (Final Rule) adopted by the SEC in August 2023. Each component of the Final Rule was vacated, including the Private Fund Audit Rule, Private Fund Quarterly Statement Rule, Private Fund Adviser Restricted Activities Rule, Adviser-Led Secondaries Rule, Preferential Treatment Rule and Books and Records Rule Amendments. In September 2023, several trade associations representing the private funds industry and other interested parties filed the lawsuit, arguing that the SEC, among other things, exceeded its statutory authority, failed to provide the public a meaningful opportunity to comment on the Final Rule, failed to perform an adequate cost-benefit analysis, and neglected its statutory duty to consider whether the Final Rule would "promote efficiency, competition, and capital formation."

On June 5, 2024, attorneys in Vedder Price's Investment Services group published an article discussing the decision, available here.

ENFORCEMENT DEVELOPMENTS

SEC Settles Charges Against Exchange for Alleged Failure to Inform SEC of Cyber Intrusion

On May 22, 2024, the SEC announced the settlement of administrative proceedings against a U.S. securities exchange and certain of its subsidiaries for their alleged failure to timely inform the SEC of a systems intrusion in violation of Rules 1002(b)(1) and 1002(b)(2) of Regulation Systems Compliance and Integrity (Regulation SCI). The rules require that covered entities notify the SEC of a system disruption or intrusion within 24 hours unless the covered entity immediately determined that the disruption or intrusion would have no or a *de minimis* impact on operations or market participants.

According to the order, the systems intrusion was first identified by the exchange on April 16, 2021, after being notified the prior day by a third party of a previously unknown vulnerability in the exchange's virtual private network (VPN), and it was confirmed that malicious code had been inserted by a known threat actor into a VPN device used to remotely access the exchange's network. Over the next several days, the exchange and its information security team took steps to analyze and respond to the intrusion, including retaining a cybersecurity firm to conduct a parallel investigation. Four days later, on April 20, 2021, the exchange's information security team determined that the intrusion was limited to the compromised device and notified the exchange's legal and compliance personnel of the intrusion. At that point, the exchange determined that the intrusion was a *de minimis* event for purposes of Regulation SCI to be reported to the SEC as part of the exchange's quarterly reports of *de minimis* systems compliance and integrity events. On April 22, 2021, in the process of assessing reports of similar vulnerabilities, the SEC staff independently contacted the exchange regarding the impact of the VPN vulnerability, and exchange personnel informed the SEC of the intrusion and its classification as a *de minimis* event.

The SEC found that the exchange and its subsidiaries violated Regulation SCI by failing to notify the SEC immediately after identifying the systems intrusion and by failing to submit a written notification pertaining to the event within 24 hours, given that the exchange did not upon identification of the intrusion conclude or reasonably estimate that the intrusion's impact was *de minimis* on its operations or on market participants.

The SEC also found that exchange failed to promptly notify its subsidiaries of the intrusion, thereby causing their violations of Regulation SCI. Without admitting or denying the allegations, the exchange and its subsidiaries agreed to cease and desist from future violations of Regulation SCI, and the exchange, having been found by the SEC to have caused its subsidiaries' violations of Regulation SCI, agreed to pay a civil monetary penalty of $10 million. In announcing the settlements, Gurbir Grewal, Director of the SEC's Division of Enforcement, stated that "[w]hen it comes to cybersecurity, especially events at critical market intermediaries, every second counts and four days can be an eternity," adding that "[t]oday's order and penalty not only reflect the seriousness of the respondents' violations, but also that several of them have been the subject of a number of prior SEC enforcement actions, including for violations of Reg SCI."

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

SEC Settles Charges Against Dually-Registered Broker-Dealer and Adviser for Alleged Failure to Address Conflicts of Interest

On May 21, 2024, the SEC announced the settlement of administrative proceedings brought against a dually-registered broker-dealer and investment adviser for its alleged failure to address conflicts of interest in compliance with Rule 15l-1(a) of the Securities Exchange Act of 1934 (Regulation Best Interest) and the Investment Advisers Act of 1940.

According to the order, between June 2020 and February 2022, the broker/adviser's representatives recommended that its clients with $1 million or more in investments consider transferring securities from their brokerage and investment advisory accounts to new accounts with an affiliated wealth management firm. The SEC alleged that the broker/adviser paid its representatives a finders' fee for referring these clients to the affiliated firm and also paid them an annual fee based on the value of the assets that were transferred to or otherwise placed in new accounts at the affiliated firm. The SEC alleged that the broker/adviser and its representatives failed to disclose these fee arrangements and the conflicts of interest associated with the transfer recommendations in writing to their clients. The SEC further alleged that the broker/adviser's written

policies and procedures were not reasonably designed to identify these conflicts of interest and address them through disclosure, mitigation or elimination. As a result, the SEC also alleged that the broker/adviser's policies and procedures were not reasonably designed to achieve compliance with Regulation Best Interest.

According to the order, the broker/adviser willfully violated Regulation Best Interest, Section 206(2) of the Advisers Act, which makes it unlawful for an adviser to engage in fraud or deceit upon any client or prospective client, and Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, which require advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder. Without admitting or denying the allegations, the broker/adviser agreed to cease and desist from future violations, to be censured, and to pay a civil monetary penalty of $223,228.

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

New York

Jeremy I. Senderowicz ..... +1 (212) 407 7740

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
Devin Eager ..... +1 (202) 312-3016
Elisa Cardano Perez ..... +1 (202) 312 3023
Laure Sguario ..... +1 (202) 312 3373

Miami

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

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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