Investment Services Regulatory Update

August 2024

Monthly Version

VedderPrice

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New Rules, Proposed Rules, Guidance and Alerts

NEW AND PROPOSED RULES

Treasury Department and IRS Issue Final Regulations Exempting Regulated Investment Companies and REITs from Filing Stock Repurchase Excise Tax Returns

On June 28, 2024, the IRS and the U.S. Treasury Department issued final regulations regarding the reporting and payment of the one percent (1%) excise tax on repurchases of publicly traded corporate stock made after December 31, 2022. The excise tax was imposed by the Inflation Reduction Act of 2022, as discussed in an article published by attorneys in Vedder Price's Tax group. The Inflation Reduction Act exempts repurchases made by a regulated investment company (as defined in Section 851 of the Internal Revenue Code) and real estate investment trusts (REITs) from the excise tax.

Although the regulations exempt regulated investment companies and REITs from the obligation to file a stock repurchase excise tax return, these entities are subject to certain recordkeeping requirements. Specifically, regulated investment companies and REITs must keep complete and detailed records sufficient to establish accurately the amount of repurchases, adjustments or exceptions that would otherwise be required to be reported on any stock repurchase excise tax return.

The final regulations took effect on June 28, 2024 and are available here.

FinCEN Issues Proposed Rule Amendments to Enhance Anti-Money Laundering/ Countering the Financing of Terrorism Requirements for Financial Institutions

On June 28, 2024, the Financial Crimes Enforcement Network (FinCEN) proposed amendments to regulations under the Bank Secrecy Act (BSA) intended to strengthen and modernize financial institutions' existing anti-money laundering/countering the financing of terrorism (AML/CFT) programs. The proposed amendments are intended to implement requirements under the Anti-Money Laundering Act of 2020 (AML Act), which comprehensively updated the BSA. While financial institutions (as defined by FinCEN), including open-end mutual funds and ETFs, are already required to maintain AML/CFT programs, FinCEN's proposal would explicitly require that such programs be "effective, risk-based and reasonably designed" and include certain minimum components. Highlights of FinCEN's proposed amendments include the following:

- ***Risk Assessment Process.*** Financial institutions would be required to develop a risk assessment process to serve as the basis of their AML/CFT programs. This risk assessment process must identify, evaluate and document the financial institution's money laundering, terrorist financing and other illicit finance activity risks (ML/TF risks), including consideration of (1) government-wide AML/CFT priorities issued by FinCEN, as appropriate; (2) the ML/TF risks of the financial institution based on its business activities, including products, services, distribution channels, customers, intermediaries and geographic locations; and (3) the reports filed by the financial institution with FinCEN pursuant to applicable BSA regulations, including suspicious activity reports and currency transaction reports. Financial institutions would be required to review and update their risk assessments on a periodic basis, including, at a minimum, when there are material changes to the financial institution's ML/TF risks.
- ***Internal Policies, Procedures and Controls.*** The proposed amendments would update existing requirements for financial institutions to develop internal policies, procedures and controls as part of their AML/ CFT programs to explicitly require that such internal

policies, procedures and controls are commensurate with the financial institution's ML/TF risks and ensure ongoing compliance with the BSA and regulations thereunder.

- ***Testing and Training.*** The proposed amendments also make changes to existing AML/CFT program training and independent testing requirements to specify that the ongoing employee training program required under the AML/CFT program must also be risk-based and to require that independent testing be conducted by qualified personnel of the financial institution or by a qualified outside party.
- ***Approval and Oversight.*** Under the proposed amendments, a financial institution's AML/CFT program must be approved and overseen by its board of directors or equivalent governing body. While board approval of AML/CFT programs is already required for certain financial institutions (e.g., open-end mutual funds and ETFs), other financial institutions are not currently subject to such requirements (e.g., broker-dealers, insurance companies and futures commission merchants).

Comments on the proposal are due on or before September 3, 2024.

FinCEN's proposing release is available here, a related fact sheet is available here and the related press release is available here.

GUIDANCE AND OTHER DEVELOPMENTS

Regulatory Agenda Highlights Potential and Pending SEC Rulemaking Topics

On July 8, 2024, the Office of Information and Regulatory Affairs, part of the Office of Management and Budget, within the Executive Office, released the Spring 2024 Unified Agenda of Regulatory and Deregulatory Actions, reporting on potential rulemaking topics that administrative agencies, including the SEC, will consider in the short and long term. These topics include several areas of interest to registered funds, investment advisers and other financial institutions. The topics are categorized in one of three rulemaking stages: proposed rule, final rule and long-term actions.

Notable changes from the Fall 2023 agenda include movement of the SEC's open-end fund liquidity risk management program and swing pricing rule amendments, safeguarding advisory client assets (i.e., custody) rulemaking, and broker-dealer and investment adviser use of predictive data analytics rulemaking from the final rule stage back to the proposed rule stage. The Spring 2024 agenda indicates these rulemaking initiatives will be re-proposed.

Proposed Rule Stage. Matters identified in the proposed rule stage include the following:

- open-end fund liquidity risk management programs and swing pricing (to be re-proposed);
- safeguarding advisory client assets to improve and modernize the regulations around the custody of funds or investments (to be re-proposed);
- broker-dealer and investment adviser conflicts of interest in the use of predictive data analytics, artificial intelligence, machine learning and similar technologies in certain investor interactions (to be re-proposed);
- Regulation D and Form D amendments, including updates to the accredited investor definition;
- registered investment companies' fees and fee disclosure—a topic that first appeared in the spring 2022 regulatory agenda but has not yet resulted in any SEC release;
- joint rulemaking with other agencies to establish data standards for the collection of information reported to each agency by financial entities under their jurisdiction, implementing the requirements of amendments to the Financial Stability Act of 2010 (a topic subsequently addressed with a proposed rule issued by the SEC and eight other federal agencies on August 2, 2024); and
- the listing and trading of exchange-traded products (ETPs) on national securities exchanges relating to a 2015 SEC request for comment.

Final Rule Stage. Matters identified in the final rule stage include the following:

- enhanced disclosures by investment advisers and funds about environmental, social and governance (ESG) practices;
- cybersecurity risk management for investment advisers and funds;
- outsourcing by investment advisers and rules related to advisers' oversight of third-party service providers;

- inflation adjustments for the dollar threshold definition of a qualifying venture capital fund (subsequently addressed by the SEC with an adopting release issued on August 21, 2024);
- proposed Regulation Best Execution, which would require detailed policies and procedures for all broker-dealers and more robust policies and procedures for broker-dealers engaging in certain conflicted transactions with retail customers, as well as related review and documentation requirements; and
- cybersecurity risk management for broker-dealers, national securities exchanges, transfer agents and other market participants.

Long-Term Actions. Matters identified in the "long-term actions" stage of rulemaking include the following:

- the role of certain third-party service providers, including index providers, model portfolio providers and pricing services, their treatment under the Advisers Act and the implications for the asset management industry; and
- the regulatory regime for transfer agents.

The list of topics in the proposed rule or final rule stages is available here; the "long-term actions" list is available here. SEC Chair Gary Gensler issued a statement in connection with the release of the regulatory agenda.

Litigation and Enforcement Matters

LITIGATION DEVELOPMENTS

FTC Rule Banning Non-Competes Held to Be Unlawful Agency Action and Set Aside

On August 20, 2024, the U.S. District Court for the Northern District of Texas granted summary judgment in favor of the plaintiff and the plaintiff-intervenors in the case of *Ryan, LLC v. Federal Trade Commission*, challenging the Federal Trade Commission's (FTC) ban on post-employment non-compete agreements (Non-Compete Rule). The court concluded that the FTC lacked statutory authority to promulgate the Non-Compete Rule, and that the Non-Compete Rule is arbitrary and capricious. Accordingly, the court set aside the Non-Compete Rule and ordered that it will not be enforceable or take effect on its original effective date of September 4, 2024 or thereafter.

Two Federal District Courts Stay DOL Fiduciary Rule

On July 25, 2024, the U.S. District Court for the Eastern District of Texas stayed the U.S. Department of Labor's (DOL) recently-issued final rule, set to take effect September 23, 2024, which would amend the definition of an "investment advice fiduciary" for purposes of the Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code (the 2024 Rule). One day later, in a separate case challenging the 2024 Rule, the U.S. District Court for the Northern District of Texas also stayed the 2024 Rule on similar grounds. Both decisions stay the effective date of the 2024 Rule indefinitely while the cases are pending.

The DOL previously attempted to redefine an investment advice fiduciary in a 2016 rulemaking, which was ultimately invalidated by the U.S. Court of Appeals for the Fifth Circuit in 2018 as being beyond the DOL's authority, with the Fifth Circuit finding that it was overbroad and applied to relationships that lacked "trust and confidence." Shortly following the DOL's adoption of the 2024 Rule, on May 2, 2024, an insurance industry trade organization, along with five other insurance industry plaintiffs, filed suit in the U.S. District Court for the Eastern District of Texas, challenging the 2024 Rule. Citing the Fifth Circuit precedent, the Eastern District Court concluded that the 2024 Rule, like the earlier 2016 rule, conflicts with ERISA in several ways. First, the court found that the extension of fiduciary status to "one-time" advice, including advice related to roll-overs, would capture transactions that do not satisfy the "relationship[s] of trust and confidence" requirement contemplated by ERISA, noting that the 2024 Rule "fails for this reason alone." Second, the court found that 2024 Rule's amended definition of an "investment advice fiduciary" conflicts with ERISA's requirement that the fiduciary render "investment advice for a fee or other compensation," noting that the amended definition captures arrangements where fees are paid either for "the recommended transaction or the provision of investment advice." The court stated that "ERISA requires that the fee be paid for investment advice, not for a mere recommendation on a financial product." Third, the court found that the 2024 Rule conflicts with ERISA by regulating IRA providers "in tandem with" Title I fiduciaries, thus "ignoring the distinction between [the] DOL's regulatory authority under Title I, which is expansive, and Title II, which is limited."

In the second case, filed by various insurance trade groups, the U.S. District Court for the Northern District of Texas cited and fully agreed with the Eastern District Court's analysis and reasoning, as outlined above, explaining how the 2024 Rule conflicts with ERISA and the Fifth Circuit precedent. In staying the 2024 Rule, both District Courts found that plaintiffs were likely to succeed on the merits of their claims.

The memorandum opinion of the U.S. District Court for the Eastern District of Texas was issued under the caption Federation of Americans for Consumer Choice, Inc., et al. v. United States Department of Labor, et al., No. 6:24-cv-163-JDK (E.D. Tex. 2024). The memorandum opinion of the U.S. District Court for the Northern District of Texas was issued under the caption American Council of Life Insurers, et al. v. United States Department of Labor, et al., No. 4:24-cv-00482-O (N.D. Tex. 2024).

ENFORCEMENT DEVELOPMENTS

SEC Settles Enforcement Proceedings Against Adviser for Alleged Marketing Rule Violation

On August 9, 2024, the SEC announced the settlement of administrative proceedings brought against a registered investment adviser for allegedly advertising hypothetical performance information on its website without adopting and implementing policies and procedures required by Rule 206(4)-1 under the Investment Advisers Act of 1940, also known as the Marketing Rule.

The SEC alleged that from November 4, 2022, through December 15, 2023, the adviser published a quarterly performance report on its public website that included hypothetical performance information for certain portfolios it offered to clients, which was derived from model portfolios. According to the SEC's order, while advertising during the relevant period, the adviser failed to adopt and implement policies and procedures reasonably designed to ensure that the hypothetical performance information contained in its advertising materials was relevant to the likely financial situation and investment objectives of the intended audience. As a result, the SEC found that the hypothetical performance information was disseminated to a mass audience rather than to a particular intended audience.

The SEC found that the adviser willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-1(d) thereunder, which make it unlawful for an investment adviser to include in an advertisement any hypothetical performance information unless the adviser, among other things, "[a]dopts and implements policies and procedures reasonably designed to ensure that the hypothetical performance is relevant to the likely financial situation and investment objectives of the intended audience of the advertisement."

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 $430,000. In agreeing to the settlement, the SEC considered the adviser's cooperation with the SEC staff. This settlement is in line with the SEC's continued focus on Marketing Rule violations. In particular, in September 2023, April 2024 and June 2024, the SEC settled enforcement actions against additional registered investment advisers involving alleged violations of the Marketing Rule.

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

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

On July 29 and July 30, 2024, the SEC announced the settlement of administrative proceedings brought against two dually registered broker-dealers and investment advisers for alleged violations of Rule 15l-1 under the Securities Exchange Act of 1934, known as Regulation Best Interest. 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 actions involve 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 or series of recommendations 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 interests. The compliance obligation requires broker-dealers to establish, maintain, and enforce written policies and procedures reasonably designed to achieve compliance with Regulation Best Interest.

July 29, 2024 Settlement Order

The July 29, 2024 order alleges that between July 2020 and January 2022 a broker-dealer acting through one of its registered representatives "unreasonably disregarded, dismissed, misunderstood, or failed to take reasonable steps to understand significant disclosures and information regarding" certain corporate bonds, known as L Bonds, that it recommended to retail customers. The SEC further alleged that in December 2021 the broker-dealer, acting through the registered representative, recommended a $50,000 L Bond with a 5-year term to a 63-year-old semi-retired retail customer with a moderate risk tolerance and whose only documented investment objective was preservation of capital and who specifically explained to the registered representative that he did not want to lose his principal. According to the SEC, the prospectus for the L Bonds disclosed that L Bonds involve a high degree of risk, including the risk of losing one's entire investment, and that L Bonds are only suitable for persons with substantial financial resources and with no need for liquidity. The SEC alleged that the broker-dealer and its registered representative failed to comply with the care obligation and willfully violated Regulation Best Interest.

Without admitting or denying the allegations, the broker-dealer and the registered representative agreed to cease and desist from future violations and to be censured, and the broker-dealer agreed to pay $5,115 in disgorgement and prejudgment interest and a civil monetary penalty of $85,000. The registered representative also agreed to a six-month suspension from certain industry activities and associations, and to pay $28,421 in disgorgement and prejudgment interest and a civil monetary penalty of $15,000.

July 30, 2024 Settlement Order

The July 30, 2024 order alleges that from July 2020 through July 2021 a registered representative of a broker-dealer employed a risky day trading strategy involving the purchase and sale of options contracts in the accounts of several customers, several of whom had moderate to conservative risk profiles. According to the order, this trading strategy resulted in the customers paying excessively large commissions to the registered representative and the broker-dealer. The SEC alleged that the registered representative's supervisor and the broker-dealer's chief compliance officer were aware of the trading activities and failed to follow the broker-dealer's policies and procedures to restrict the trading activity, and 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 $140,000. The SEC noted the broker-dealer's cooperation during the SEC's investigation and the broker-dealer's remedial actions, including senior management changes, payment of financial remediation to affected customers, and improvements to its policies and procedures.

The July 29, 2024 order is available here, and a related press release is available here. The July 30, 2024 order is available here.

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