Investment Services Regulatory Update

January 2025
Monthly Version

VedderPrice

New Rules, Proposed Rules, Guidance and Alerts

GUIDANCE AND OTHER DEVELOPMENTS

SEC Staff Updates Names Rule FAQs

On January 8, 2025, the SEC staff published updated frequently asked questions (FAQs) related to Rule 35d-1 under the Investment Company Act of 1940 (known as the Names Rule). The staff issued the updated FAQs, and withdrew certain Names Rule FAQs issued in 2001, in light of the amendments to the Names Rule that the SEC adopted in 2023. Among other things, the amended Names Rule provides that a fund's name may not use terminology suggesting that the fund invests its assets in a particular type of investment, industry, group of industries, country, geographic region, or in investments that have, or whose issuers have, particular characteristics, unless the fund adopts a fundamental or nonfundamental policy to invest, under normal circumstances, at least 80% of its assets in the investments suggested by its name (80% Investment Policy). As a reminder, the compliance date for the amended Names Rule is December 10, 2025 for larger entities and June 10, 2026 for smaller entities. The January 2025 FAQs address the following Names Rule topics:

80% Investment Policy. The staff explained that shareholder approval is not required for a fund to adopt or revise a fundamental policy in order to comply with the amended Names Rule, unless the fund's new fundamental policy deviates from an existing fundamental policy.

Municipal, Tax-Exempt, and Tax-Sensitive Funds. Funds with names suggesting that the fund's distributions are exempt from federal income tax, or from both federal and state income tax (e.g., the Maryland Tax-Exempt Fund), are required to adopt a fundamental 80% Investment Policy. These funds must use either an asset test or an income test to satisfy the 80% Investment Policy. A single-state tax-exempt fund may include a security of an issuer located outside of the named state in its 80% basket if the security pays interest that is exempt from both federal income tax and the tax of the named state, provided that the fund discloses in its prospectus that it may invest in tax-exempt securities of issuers located outside of the named state. The use of the term "tax-sensitive," "tax-advantaged," "tax-efficient," or other similar terms in a fund name does not require the adoption of an 80% Investment Policy, but such funds remain subject to the prohibition in Section 35(d) of the 1940 Act on materially misleading or deceptive names. The terms "municipal" and "municipal bond" in a fund's name suggest the fund's distributions are exempt from income tax and funds with these terms in their names are expected to adopt a corresponding fundamental policy. However, funds that use the term "municipal" rather than "tax-exempt" may count securities that generate income subject to the alternative minimum tax toward the 80% investment requirement, while funds that use the term "tax-exempt" may not.

Specific Terms Commonly Used in Fund Names. The amended Names Rule broadened the scope of the 80% Investment Policy requirement to include fund names suggesting a focus on investments or issuers with "particular characteristics" (e.g., a fund name with terms such as "growth" or "value," or terms indicating that the fund's investment decisions incorporate one or more environmental, social, or governance factors). In the FAQs, the SEC staff clarified its views as to the application of the amended Names Rule to certain commonly used terms:

- *"High-yield"* – The term "high-yield" is generally understood to describe corporate bonds that are below certain creditworthiness standards, and use of "high-yield" in a fund's name therefore generally requires the fund to adopt an 80% Investment Policy. However, if used with the term "municipal," "tax exempt," or similar terms, the staff would not object if the fund invested less than 80% of the value of its assets in high-yield bonds. However, the fund would still be required to adopt an 80% Investment Policy to invest in "municipal" or "tax-exempt" securities.
- *"Income"* – When the term "income" in a fund's name suggests that the fund emphasizes the achievement of current income as a portfolio-wide result, and not fixed income securities, the fund generally would not be required to adopt an 80% Investment Policy.
- *"Money market"* – Money market funds with generic names that suggest investments in money market instruments generally (e.g., the XYZ Money Market Fund) do not need to adopt an 80% Investment Policy because Rule 2a-7 under the 1940 Act requires money market funds to invest solely in eligible securities, as defined by that rule. Fund

names suggesting investments in specific types of money market instruments (e.g., XYZ U.S. Treasury Money Market Fund) would require the fund to adopt a policy to invest at least 80% of its assets in the specified money market instruments (e.g., U.S. Treasury securities).

The January 2025 Names Rule FAQs are available here.

A chart showing the 2001 Names Rule FAQs that the SEC staff withdrew is available here.

SEC Staff Issues Guidance on Common Tailored Shareholder Reporting Issues

On November 8, 2024, the staff of the Disclosure Review and Accounting Office of the SEC's Division of Investment Management issued an Accounting and Disclosure Information (ADI) publication to highlight common issues the SEC staff has observed in funds' tailored shareholder reports (TSRs) filed with the SEC and to suggest certain fund practices that may assist investors. In January 2024, the staff of the SEC's Division of Investment Management issued guidance on TSRs in the form of frequently asked questions (FAQs), as summarized here.

The ADI publication focuses on fund practices and recurring issues in the following areas.

- **Expense Information.** With respect to semi-annual reports, the staff stated that fund expense information in dollars must reflect the dollar cost over the period and therefore should not be annualized, whereas fund expense information as a percentage of investment must be shown on an annualized basis, and suggested that funds consider noting that expense information as a percentage of investment is shown on an annualized basis. The staff also clarified that fund expense information as a percentage of investment must be calculated based on the average account value over the period, rather than the initial investment amount (e.g., $10,000). In addition, the staff noted that fund expense information in dollars should be rounded to the nearest dollar.
- **Management's Discussion of Fund Performance (MDFP).** The staff stated that a fund's average annual total returns table must present performance based on the fund's net asset value, observing that many ETFs also present performance based on market value, which is not permitted. With respect to the requirement to compare fund performance to an appropriate broad-based securities market index, the staff reminded funds that industry-focused indexes, indexes with characteristics such as growth, value, or small- or mid-cap, and other indexes that comprise only a subset of the overall applicable market do not qualify as appropriate broad-based securities market indexes. The staff also reminded funds that they are required to include a "noticeable and prominent" statement to the effect that past performance is not a good predictor of the fund's future performance.
- **Fund Statistics.** The staff observed that some funds disclose certain portfolio-level statistics, such as average maturity or average credit rating, under the heading "Graphical Representation of Holdings," noting that such statistics should instead be disclosed under the heading "Fund Statistics."
- **Graphical Representation of Holdings.** The staff noted that fund holdings disclosed as a percentage must specify if the percentage is based on net asset value, total investments, or total or net exposure. The staff also noted that if a fund categorizes its holdings based on credit quality, the fund must include a brief description of how the credit quality was determined, and if credit ratings from credit rating agencies are used, also include a concise explanation of how they were identified and selected.
- **Material Changes.** The staff observed that some funds disclosed material fund changes without including the corresponding required statement on the cover page that the report describes material fund changes, while other funds included the required statement but did not include disclosures describing the material fund changes.
- **Availability of Additional Information Online.** The staff observed funds including in their TSRs broken hyperlinks intended to direct investors to the fund's website where additional information can be accessed, as well as hyperlinks that work but do not lead investors directly to the additional information or to a central site with prominent links to the referenced information. With respect to the information required by Items 7-11 of Form N-CSR, which is required to be made available on the fund's website, the staff suggested that funds consider using a more descriptive label for the document that includes this information, such as "Annual Financial Statements and Additional Information," rather than "annual reports," "N-CSR" or "Financial Statements."

- **Inline XBRL Data Tagging.** The staff noted that some funds have identified additional comparative performance indexes as "broad-based" indexes in their Inline XBRL tagging, rather than tagging the additional indexes with the separate tag intended for such indexes.

- **Additional Issues.** The staff observed that some funds have included disclosures that are not required or permitted, such as disclaimers or risk disclosures. The staff also reminded funds that they are required to disclose the information in their TSRs in the same order as is required under Item 27A of Form N-1A and that funds may omit disclosures that may be inapplicable, such as material fund changes and changes in and disagreements with accountants.

The ADI publication noted that the Disclosure Review and Accounting Office expects to update the publication from time to time to include additional information. The publication is available here.

SEC Staff Issues Risk Alert Regarding Deficiencies Observed in Fund Compliance Programs, Disclosures and Filings, and Governance Practices

On November 4, 2024, the staff of the SEC's Division of Examinations issued a risk alert highlighting deficiencies and weaknesses identified in examinations over the past four years in three core areas: fund compliance programs, disclosures and filings, and governance practices. In addition, as a resource to funds and advisers, the risk alert includes a typical information request list that would be provided as part of the SEC examination process. The staff noted that it was providing the risk alert to assist funds and their advisers in preparing for an examination.

Examples of deficiencies and weaknesses noted by the staff included:

Compliance Programs

- Funds failing to perform required oversight or reviews or perform required assessments of the effectiveness of their compliance programs;

- CCOs failing to provide written annual compliance reports to fund boards;

- Funds failing to adopt, implement, update and/or enforce policies and procedures, including those related to, among other areas, custody, derivatives and liquidity risk management programs, valuation and portfolio management;

- Policies and procedures that were not tailored to the funds' business model or were incomplete, inaccurate or inconsistent with actual practices; and

- Funds' codes of ethics that were not adopted, implemented, followed or enforced, or were otherwise inadequate.

Disclosures and Filings

- Fund registration statements, fact sheets, and annual and semi-annual reports that were incomplete or contained outdated or potentially misleading information, such as disclosures of investment processes that were inconsistent with actual practices;

- Sales literature, including websites, that appeared to contain untrue statements or omissions of material fact, such as funds described as "no-load" that charged such fees and funds mischaracterizing the use of ESG factors in their investment processes; and

- Fund filings that were not made or were not made on a timely basis.

Governance Practices

- Fund board approvals of advisory agreements that appeared to be inconsistent with the Investment Company Act of 1940 and/or the funds' compliance policies and procedures, including issues such as failing to timely review advisory agreements, failing to request, obtain and consider certain information related to the advisory agreements, and failing to consider material changes to the advisory agreements;

- Fund boards that did not receive information to effectively oversee fund practices, such as information on illiquid investments and changes to funds' compliance programs;

- Fund boards that did not perform required responsibilities, such as failing to make certain required determinations under the 1940 Act; and

- Fund board minutes that did not fully document board actions, such as the approval of funds' liquidity risk management programs or the board's process in approving the advisory agreement.

The risk alert is available here.

Litigation and Enforcement Matters

LITIGATION DEVELOPMENTS

Corporate Transparency Act Update – Fifth Circuit Reinstates Nationwide Injunction

Vedder Price attorneys recently published an update, available here, on the Corporate Transparency Act. They reported that on December 23, 2024, a three-judge panel of the Fifth Circuit Court of Appeals granted the U.S. government's motion to stay enforcement of the nationwide injunction issued by the district court in the *Texas Top Cop Shop* litigation. On December 26, 2024, the full Fifth Circuit reversed the three-judge panel and reinstated the nationwide injunction, halting the enforcement of the Corporate Transparency Act.

District Court Vacates SEC's New Rules Expanding the Definition of Dealers

On November 21, 2024, the U.S. District Court for the Northern District of Texas granted summary judgment to plaintiffs in two parallel lawsuits that challenged the SEC's February 2024 adoption of new Rules 3a5-4 and 3a44-2 under the Securities Exchange Act of 1934, which expanded the definition of "dealer" and "government securities dealer" in Sections 3(a)(5) and 3(a)(44) of the Exchange Act. The expanded definitions required persons that engage in a regular pattern of buying and selling securities that has the effect of providing liquidity to other market participants (e.g., proprietary trading firms providing market liquidity) to register with the SEC and become members of a self-regulatory organization (e.g., FINRA).

The court held that the Exchange Act's text and legislative history indicate that a person must have customers in order to meet the definition of "dealer" and be subject to the Exchange Act. The court vacated the new rules, concluding that "the SEC exceeded its statutory authority by expanding [the] definition of dealer, untethered from the text, history, and structure of the [Exchange] Act."

The two orders were issued under the captions: *National Association of Private Fund Managers; Alternative Investment Management Association Limited; and Managed Funds Association v. SEC*, No. 4:24-cv-00250-O (N.D. Tex. 2024), and *Crypto Freedom Alliance of Texas, et al. v. SEC*, No. 4:24-cv-00361-O (N.D. Tex. 2024).

Jury Finds Former Mutual Fund Portfolio Manager Liable for Making Untrue Statements Regarding Risk Management

On November 15, 2024, the U.S. District Court for the Western District of Wisconsin entered a final judgment against a former mutual fund portfolio manager (PM) for negligent misrepresentations to fund investors regarding the fund's risk management. Separate lawsuits were filed by the SEC and the CFTC against the PM, which were consolidated for trial. On April 18, 2022, a jury found the PM liable for negligence-based securities and commodities fraud, but not for any claims requiring proof of scienter (i.e., that the PM's actions were done knowingly or recklessly). The court ordered the PM to pay the SEC and the CFTC an aggregate amount of approximately $11.2 million, consisting of approximately $7.7 million in disgorgement, $1.8 million in prejudgment interest and a $1.6 million civil penalty, and enjoined the PM from managing or advising on investments in securities or commodity futures for any third parties, except for certain family members, until April 18, 2027.

According to the order, the mutual fund managed by the PM was intended to provide a hedge against a downturn in the S&P 500 Index, while still allowing for a positive return in a slowly rising market, through the use of futures options. The order states that, in weekly "house calls" with investment advisers and investors in the fund, the PM had represented, among other things, that the fund was actively managed to prevent losses greater than 8% of the fund's assets and that daily stress testing was performed as part of the risk management process. Further, the PM had stated that when the stress testing indicated a risk of greater than 8% losses, the PM would reposition the portfolio to ensure that an 8% drawdown would be the "worst-case scenario." The order states that despite the fund facing potential losses greater than 8% in 2016 and early 2017, as indicated by the stress testing, the PM failed to take steps to limit the risk of losses to 8%. According to the order, when the S&P 500 Index rose by 2.5% within a single week in early February 2017, the fund's value declined by approximately 17%, and when 98% of the fund's options came due in February and March 2017, the fund lost more than $700 million, approximately 20% of its value at the time.

The jury found that the PM's failure to manage the fund to limit downside risk to 8% by daily stress testing violated anti-fraud provisions of the federal securities laws, specifically Sections 17(a)(2) and 17(a)(3) of the Securities Act of 1933, Sections 206(2) and 206(4) of the Investment Advisers Act of 1940 and Rule 206(4)-8 thereunder, and Section 4o(1)(B) of the Commodity Exchange Act. None of the foregoing violations require proof of scienter and, as noted above, the jury did not find the PM liable for violating other sections of the applicable securities and commodities laws that require proof of scienter.

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

ENFORCEMENT DEVELOPMENTS

SEC Enforcement Highlights for Fiscal Year 2024

On November 22, 2024, the SEC announced its enforcement results for the fiscal year ended September 30, 2024. Though the SEC filed only 583 total enforcement actions in fiscal year 2024—a decline of 26% from the 784 enforcement actions filed in fiscal year 2023—the SEC obtained a record-setting $8.2 billion in financial remedies, which includes civil penalties and disgorgement amounts combined. Notably, 56% of the $8.2 billion in financial remedies was the result of a monetary judgment awarded in a single matter.

Attorneys in Vedder Price's Government Investigations and White Collar Defense group recently published an article discussing the SEC's fiscal year 2024 enforcement results, available here.

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

On October 31, 2024, the SEC announced the settlement of several administrative proceedings brought against the broker-dealer and registered investment adviser subsidiaries of a global financial services firm for alleged disclosure and conduct violations, including those relating to recommendations to retail brokerage customers of certain mutual funds when materially less expensive "clone" ETFs with identical investment strategies were also available. Without admitting or denying the findings in the SEC's orders, the affiliates agreed to pay more than $151 million in combined civil penalties and voluntary payments to investors to resolve four of the actions. The alleged disclosure failures and/or conduct at issue are summarized below.

- **Alleged Reg BI Violations Involving "Clone" Mutual Funds and ETFs.** The SEC alleged that registered representatives of a dually registered investment adviser and broker-dealer subsidiary recommended certain mutual funds to its retail brokerage customers when the same asset management company sponsor offered a less expensive ETF with identical investment strategies to the mutual fund (referred to in the SEC's order as "clone" funds). As a result of these recommendations, retail brokerage customers made approximately 17,494 purchases of more expensive mutual funds during the relevant period, resulting in such customers paying higher fees, totaling approximately $14.03 million, than they would otherwise have paid had they purchased the clone ETFs. Because the firm and its registered representatives allegedly failed to consider the costs associated with the mutual funds as opposed to the less expensive clone ETFs, and failed to have a reasonable basis to believe that the recommendations were in the best interest of the retail brokerage customers, the SEC found that the firm violated the care obligation of Regulation Best Interest (Reg BI). The firm also allegedly violated Reg BI's compliance obligation by failing to enforce its written policies and procedures reasonably designed to achieve compliance with Reg BI's care obligation. In this particular instance, the SEC's order cited the self-reporting and remedial acts promptly undertaken by the firm, as well as the cooperation of the firm afforded to the SEC staff, in determining not to impose a civil penalty. Among other things, the firm remediated the conduct by repaying impacted customers in full plus interest; converted impacted customers into a lower-price share class of the mutual fund, which the impacted customers were not otherwise eligible to purchase, to approximate the lower fees of the clone ETFs; and undertook an investigation to confirm that there were no other "clone pairs" of mutual funds and ETFs available for recommendation on its platform to retail brokerage customers.

- **Alleged Prohibited Joint Transactions Involving Money Market Funds and an Affiliated Foreign Fund.** The SEC alleged that a registered investment adviser subsidiary that managed three U.S. money market funds caused prohibited joint transactions with an affiliated foreign money market fund that advantaged the foreign fund over the domestic funds. Specifically, the SEC alleged that the firm structured transactions in order to provide the foreign fund with indirect access to the Money Market Fund Liquidity Facility (MMLF) established by the Federal Reserve at the onset of the COVID-19 pandemic. The foreign fund and many of its assets were not eligible for the MMLF, despite the firm's efforts to persuade the Fed to expand the program to include foreign money market funds. Although the Fed communicated to the firm that it did not plan to issue any guidance that would *prevent* the transactions contemplated by the adviser, the SEC's order states that the Fed was not asked to and did not opine on whether the transactions would comply with the federal securities laws—which, according to the SEC, did not so comply. Rather, the SEC alleged, the transactions among the domestic funds and the foreign fund violated Section 17(d) of the Investment Company Act of 1940 and Rule 17d-1 thereunder. According to the SEC's order, the domestic funds earned only one-tenth of the investment gain that the foreign fund made from the transactions while bearing certain risks in the transactions that the foreign fund did not bear. In addition to other administrative sanctions imposed by the SEC, the adviser was ordered to pay a civil penalty of $5 million.

- **Alleged Prohibited Principal Transactions Involving Registered Funds and Other Clients.** The SEC alleged that over a 20 month period a registered investment adviser subsidiary engaged in or caused 65 prohibited principal trades with a combined notional value of approximately $8.2 billion and which included approximately $22,000 in spreads. According to the SEC's order, the adviser's portfolio manager directed an unaffiliated broker-dealer to buy commercial paper or similar short-term fixed income securities from the adviser's affiliated broker-dealer and, thereafter, the adviser purchased the paper from the unaffiliated broker-dealer on behalf of its clients. Although the SEC had granted the adviser exemptive relief permitting it to trade with its affiliated broker-dealer provided certain conditions were met, the SEC alleged that the transactions involving the registered funds did not comply with those conditions, thus causing violations of Section 17(a)(1) of the Investment Company Act. In its order, the SEC stated, "The interpositioning of a broker-dealer in a transaction that, in absence of such party, otherwise represents a principal trade does not remove the prohibition of such transactions under Section 17(a)." As to transactions involving non-registered fund clients, the SEC alleged that the adviser neither provided required client disclosures nor obtained client consent, thereby violating Section 206(3) of the Investment Advisers Act of 1940. While the SEC's order cited the adviser's remedial acts and cooperation, including promptly providing documents, communications and other information on an ongoing, voluntary basis to the SEC's enforcement staff, and providing additional training to employees and updating policies and procedures, the adviser was censured, ordered to cease and desist engaging in the alleged violations and directed to pay a civil penalty of $1 million.

- **Alleged Disclosure Failures Involving Financial Incentives and Product Management Practices.** The final two administrative proceedings pertained to alleged disclosure violations by a dually registered investment adviser and broker-dealer subsidiary. One proceeding related to the firm's alleged failure to fully and fairly disclose its financial incentive to recommend its discretionary wrap fee program to clients over other advisory programs it offered that used third-party managers, as well as related failures to adopt and implement written compliance policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder in connection with the disclosure of conflicts of interest presented by the fee structure of the programs. The foregoing proceeding resulted in the imposition of a $45 million civil penalty. Finally, in a proceeding involving brokerage customers who invested in certain private fund-of-funds to access private equity or hedge funds that customers might not be able to access directly, the SEC alleged that the firm's practices related to sales of shares of underlying portfolio companies were not consistent with the offering document and offering agreement disclosures to the brokerage customers, thus violating Sections 17(a)(2) and 17(a)(3) of the Securities Act of 1933.

A press release issued by the SEC, including links to each of the SEC's orders, 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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