Investment Services Regulatory Update

February 2025
Monthly Version

VedderPrice

New Rules, Proposed Rules, Guidance and Alerts

NEW AND PROPOSED RULES

Third Set of Form PF Amendments to Take Effect on June 12, 2025

Attorneys in Vedder Price's Investment Services Group recently published a bulletin, available here, on the third set of amendments to Form PF, the confidential reporting form for certain SEC-registered investment advisers to private funds. The bulletin reports the recent extension of the compliance date by the SEC and the CFTC from March 12, 2025 to June 12, 2025. The joint final rule extending the compliance date is available here.

President Trump Issues "Regulatory Freeze" Memorandum

On January 20, 2025, President Donald Trump issued a presidential memorandum (Memo) ordering all executive departments and agencies to temporarily pause certain regulatory actions until they can be reviewed and approved by designated officials in the Trump Administration and to consider temporarily postponing the effective dates of certain previously-adopted regulations.

Specifically, the Memo orders all executive departments and agencies to:

- Refrain from proposing or issuing any new rules, including by sending a rule for publication in the *Federal Register*, until a department or agency head appointed or designated by President Trump reviews and approves the rule;
- Immediately withdraw any rules that have been sent for publication but have not yet been published in the *Federal Register*, so that they can be reviewed and approved as described above; and
- Consider postponing for 60 days (i.e., until March 21, 2025) the effective date for any rules that have been published in the *Federal Register*, or any rules that have been otherwise issued but have not taken effect, and consider opening a comment period to "allow interested parties to provide comments about issues of fact, law, and policy raised by the rules."

The Memo authorizes the Director or Acting Director of the Office of Management and Budget (OMB Director) to exempt any rule deemed necessary to "address emergency situations or other urgent circumstances, including rules subject to statutory or judicial deadlines that require prompt action." The Memo also designates the OMB Director as the individual responsible for overseeing the implementation of the Memo.

The Memo is available here.

GUIDANCE AND OTHER DEVELOPMENTS

FINRA Publishes 2025 Regulatory Oversight Report

On January 28, 2025, FINRA published its annual regulatory oversight report for 2025 (Report), which highlights observations and findings from FINRA's oversight programs. The Report covers 24 topics, and for each topic it identifies the relevant rule(s), summarizes noteworthy findings or observations, outlines effective practices observed, and provides additional resources that may be helpful to firms in reviewing their supervisory procedures and controls and fulfilling their compliance obligations. The topics reflect areas where FINRA has observed gaps in firm compliance programs as well as areas of emerging or increased risk.

Two new topics are covered in the Report for 2025—the third-party vendor risk landscape and extended hours trading. The Report notes that FINRA has observed an increase in cyberattacks and outages at third-party vendors used by member firms, and given the financial industry's reliance on third-party vendors to support key systems and covered activities, an attempted cyberattack or an outage at a third-party vendor could potentially impact a large number of firms. Regarding extended hours trading, the Report notes that FINRA has observed that trading in National Market System (NMS) stocks and other securities has increasingly stretched beyond regular trading hours. The Report reminds firms that offer extended trading hours of the requirements of FINRA Rule 2265 (Extended Hours Trading Risk Disclosure), including the requirement to provide customers with a risk disclosure statement. The Report also highlights new content regarding perennial topics in the annual report, including content related to generative artificial intelligence and investment fraud by bad actors targeting investors directly.

FINRA advises members firms to review the Report and consider incorporating relevant elements into their compliance programs in a manner tailored to each firm's activities and applicable regulatory requirements.

The Report can be found here.

SEC Staff Provides Guidance on Issues Related to Website Posting Requirements

On January 16, 2025, 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 issues the SEC staff has observed relating to website posting requirements under various SEC rules and certain exemptive orders. The ADI publication focuses on issues related to summary prospectuses, ETFs and money market funds (MMFs), as further described below.

Summary Prospectuses

- **Website Address at Which Required Documents Are Available**. The staff observed that some fund summary prospectuses did not include a website address where required fund documents can be found or included a generic website address for the fund's home page. The staff noted that the website address should take investors directly to a webpage where the required documents can be found.

- **Linking of Table of Contents**. The staff observed that some funds did not include a table of contents in the statutory prospectus and/or the statement of additional information (SAI) that was hyperlinked to allow the reader to move directly between the tables of contents and the related sections of the document.

- **Linking Between Summary Prospectus and Statutory Prospectus/SAI.** The staff also observed that some funds did not include any hyperlinking from the summary prospectus to the statutory prospectus and SAI, or only partially satisfied the hyperlinking requirement.

- **Variable Products**. The staff observed that some variable product funds did not include the permitted means of accessing definitions of special terms in the summary prospectus, either by enabling the reader to view the definition upon command or by hyperlinking the term to a corresponding glossary entry.

Exchange-Traded Funds

- **Daily Holdings**. The staff noted that some ETFs did not include CUSIPs or other identifiers with their daily holdings information, as required by Rule 6c-11 under the Investment Company Act of 1940 (the ETF Rule).

- **Daily Market Information**. The staff observed that some ETFs reported their premium and discount information in dollars, rather than as percentages as required by the ETF Rule, and that some ETFs used alternative terminology when referring to premiums and discounts, which, in the staff's view, may be confusing to investors.

- **Historic Premium and Discount Information**. The staff noted that some ETFs' premium and discount disclosures were not updated timely to reflect the most recent quarter-end information. The staff further noted that for some ETFs, it could not locate, or had difficulty locating, the ETF's historic premium and discount information on its website.

- **30-Day Median Bid-Ask Spread**. The staff found that some ETFs used alternative terminology when referring to the 30-day median bid-ask spread (e.g., omitting the reference to "30-day"), such that the figure may be unclear to investors.

- **Disclosure of ETF Premiums or Discounts Greater than 2%**. The staff observed that, for ETFs that had a premium or discount greater than 2% for more than seven consecutive trading days, a significant number of them did not disclose that fact on their website along with a discussion of the factors reasonably believed to have materially contributed to the premium or discount.

Money Market Funds

- The staff observed that several MMFs did not post on their websites the required link to the SEC's website where investors may obtain the most recent 12 months of the MMF's publicly available portfolio holdings information filed on Form N-MFP.

The ADI publication is available here.

Litigation and Enforcement Matters

ENFORCEMENT DEVELOPMENTS

SEC Settles Enforcement Proceedings Against Quantitative Hedge Fund Manager for Alleged Algorithmic Model Vulnerabilities

On January 16, 2025, the SEC announced the settlement of administrative proceedings brought against a hedge fund manager that used algorithmic investment models to provide investment advice to its private fund and separately managed account (SMA) clients. The order alleged that the manger breached its fiduciary duty by failing to exercise reasonable care in addressing known vulnerabilities to certain models. The order also identified alleged failures by the manager to reasonably supervise one of its modelers and alleged violations of Rule 21F-17(a) under the Securities Exchange Act of 1934, also known as the Whistleblower Protection Rule.

According to the order, between March 2019 and October 2023, the manager knew of, but failed to address, significant vulnerabilities to certain of its algorithmic investment models due to lack of access controls. As described in the order, a large number of the manager's employees had "read and write" access to a database that stored these models, allowing the employees to change model parameters without review or approval, which could materially impact the manager's investment decisions for its clients. Senior personnel were allegedly made aware of the vulnerabilities as early as March 2019, but did not take reasonable steps to address the vulnerabilities until October 2023, in connection with an examination by the SEC's Division of Examinations. During the course of the examination, the manager also disclosed to SEC staff and to investors that one of its modelers had made a number of unauthorized changes to the models, which the manager described as "intentional misconduct," resulting in significant compensation to the modeler and causing certain funds and SMAs advised by the manager to underperform by approximately $165 million and other funds and SMAs to outperform by more than $400 million. The manager voluntarily repaid the adversely impacted funds and SMAs the full amount of the underperformance in December 2023 and January 2024. In addition, the order alleged that the manager separately violated the Whistleblower Protection Rule by entering into separation agreements with departing employees that required the employees to represent that they had not previously filed a complaint against the manager with any governmental agency.

The SEC found that the manager 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)-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; (3) Section 203(e)(6) of the Advisers Act for failing to reasonably supervise its modeler; and (4) the Whistleblower Protection Rule, which prohibits any person from taking any action to impede an individual from communicating directly with the SEC staff about a possible securities law violation.

Without admitting or denying the allegations, the manager agreed to cease and desist from future violations, to be censured and to pay a civil monetary penalty of $90 million. The order acknowledged the cooperation the manager afforded the SEC staff and the remedial actions the manager promptly undertook.

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

SEC Settles Enforcement Proceedings Against Investment Adviser Regarding Alleged Misleading Disclosure Concerning Capital Gains Distributions

On January 17, 2025, the SEC announced the settlement of administrative proceedings brought against a registered investment adviser for allegedly making materially misleading statements relating to capital gains distributions and potential tax consequences to retail investors in target date mutual funds advised by the adviser and held in taxable accounts. The settlement also resolved parallel investigations of the adviser by securities regulators of numerous U.S. states and territories which was coordinated by the North American Securities Administrators Association (NASAA). In addition, on November 25, 2024, the U.S. District Court for the Eastern District of Pennsylvania preliminarily approved a settlement between the adviser and a class of retail investors in the target date funds who claimed that the adviser breached its fiduciary duty.

The settlements relate to a December 2020 reduction in the investment minimum for "institutional" versions of the target date funds from $100 million to $5 million, following which it is alleged that there was an "elephant stampede" out of the more costly retail funds and into the more affordable institutional funds. The SEC and retail investor plaintiffs claimed that the significant redemptions out of the retail funds led to an unprecedented sale of assets by the retail funds to fulfill the redemptions, which led to a sharp spike in capital gains distributed to shareholders that did not leave the retail funds.

The SEC Order

According to the SEC order, the prospectuses for the target date funds were materially misleading because, although they stated that the funds' distributions may be taxable as ordinary income or capital gains and that capital gains distributions could vary considerably from year to year as a result of the funds' "normal" investment activities and cash flows, the prospectuses failed to disclose the potential for unusually large capital gains distributions resulting from redemptions by investors who switched to the institutional versions of the target date funds in which they were now eligible to invest. The SEC also alleged that the adviser failed to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and rules thereunder with respect to the accuracy of the funds' disclosures.

The SEC found that the adviser violated the anti-fraud provisions of the Investment Advisers Act of 1940, specifically Section 206(4) and Rules 206(4)-7 and 206(4)-8 thereunder. The SEC also found that the adviser caused the funds to violate the anti-fraud provisions of the federal securities laws, specifically Section 17(a)(2) of the Securities Act of 1933 and Section 34(b) of the Investment Company Act of 1940.

Without admitting or denying the allegations, the advisor agreed to cease and desist from future violations, to be censured, to pay $18.2 million in disgorgement and prejudgment interest (that will be deemed satisfied by the adviser's payment of $92.91 million in relief pursuant to the multi-state settlement) and to pay a civil monetary penalty of $13.5 million, for a total amount of $106.41 million to be distributed to affected investors. The $92.91 million due pursuant to the multi-state settlement is based on the adviser's agreement to pay $135 million in remediation, which the adviser is entitled to offset by the $40 million class action settlement (to the extent the settlement is finalized) discussed below and $2.09 million in other claims. In agreeing to the settlement, the SEC considered the adviser's remedial actions and cooperation afforded the SEC staff.

Class Action Settlement

As stated above, on November 25, 2024, the U.S. District Court for the Eastern District of Pennsylvania preliminarily approved a settlement between the adviser and a class of retail investors in the target date funds who claimed that the adviser breached its fiduciary duty when it reduced the investment minimum for the institutional versions of the target date funds leading to the significant redemptions out of the retail versions of the funds and the resulting capital gains distributions to the remaining investors in the retail funds. Pursuant to the settlement, which is subject to further consideration at a March 11, 2025 hearing, the adviser will pay $40 million into a settlement fund to be dispersed to the class of plaintiff investors who submit a proof of claim. Subsequently, certain class members have filed objections to the settlement, claiming that the amount of the settlement is too small and the proposed attorneys' fees (representing approximately one-third of the settlement amount) are too large. Should the settlement be terminated or withdrawn, or rejected by the court, the $40 million settlement amount will be added back to the $92.91 million due under the multi-state settlement.

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

The NASAA press release regarding the multi-state settlement is available here.

The stipulation of settlement and related order and motion were issued under the caption *In Re Vanguard Chester Funds Litigation*, No. 2:22-cv-00955 (E.D. Pa.).

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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.

Recognized by *Chambers USA* and *Chambers Global* in the Investment Funds: Registered Funds category

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