# Investment Services Regulatory Update

February 2022

Monthly Version

VedderPrice

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# New Rules, Proposed Rules, Guidance and Other Developments

## PROPOSED RULES

### SEC Proposes a Variety of Rules Applicable to Security-Based Swaps

On December 15, 2021, the SEC proposed new rules requiring that large positions in security-based swaps and related securities be reported to the SEC and publicly disseminated. At the same time, the SEC re-proposed regulations prohibiting fraudulent, deceptive and manipulative conduct in connection with security-based swaps. The SEC also proposed new rules restricting the personnel of security-based swap dealers from taking action to influence the chief compliance officer of the security-based swap dealer in the performance of its duties.

- **Proposed Rule 10B-1: Position Reporting of Large Security-Based Swaps.** Rule 10B-1 would require any person, affiliate of such person or group of persons who would directly or indirectly be the owner or seller of a security-based swap to report such security-based swap position on EDGAR, subject to certain thresholds. The thresholds would vary based on the type of swap and, in certain circumstances, include the value of any underlying securities owned by the holder of the reportable security-based swap position in determining whether the threshold has been met. The information on security-based swaps positions would be required to be filed on EDGAR within one business day of execution of the relevant position and would be publicly disseminated. The rule is intended to increase transparency in security-based swaps positions. In the proposing release, the SEC expressed concern about manufactured credit events triggering credit default swaps and the risks of concentrated positions that are not known to the market or regulators. Based on the SEC's statements, the reporting of such large security-based swaps positions would alert market participants as to possible financial incentives a market participant might have to act contrary to the interests of the issuer and its stakeholders. The SEC stated that such transparency would be beneficial to the market even where there is no fraud, manipulation or deceptive conduct on the part of the owner of the large security-based swaps position. This appears to be based on the premise that such public reporting could help inform pricing and enhance the risk management of dealers where one market participant has built up a large position across a number of dealers by alerting the dealer as to significant exposure with respect to the same security-based swap.
- **Re-Proposed Rule 9j-1: Anti-Fraud and Anti-Manipulation.** The SEC originally proposed anti-fraud, deception and manipulation rules with respect to security-based swaps in 2010. The proposed rule explicitly would have addressed misconduct in connection with offers, purchases and sales of security-based swaps and also would have applied to cash flows, payments, deliveries and other ongoing obligations and rights specific to security-based swaps. The new re-proposed rule would prohibit fraudulent, deceptive and manipulative conduct in connection with security-based swaps and also includes anti-manipulation rules similar to those promulgated by the Commodity Futures Trading Commission. The rule would prohibit persons in possession of material non-public information (MNPI) from using swaps to gain exposure to securities and avoid the liability that would otherwise arise from directly purchasing the relevant securities while in possession of MNPI. In addition, the rule would make it unlawful for any officer, director, supervised person or employee of a security-based swap dealer or major security-based swap participant to coerce, manipulate, mislead or fraudulently influence the entity's chief compliance officer in the performance of its duties under the securities laws.

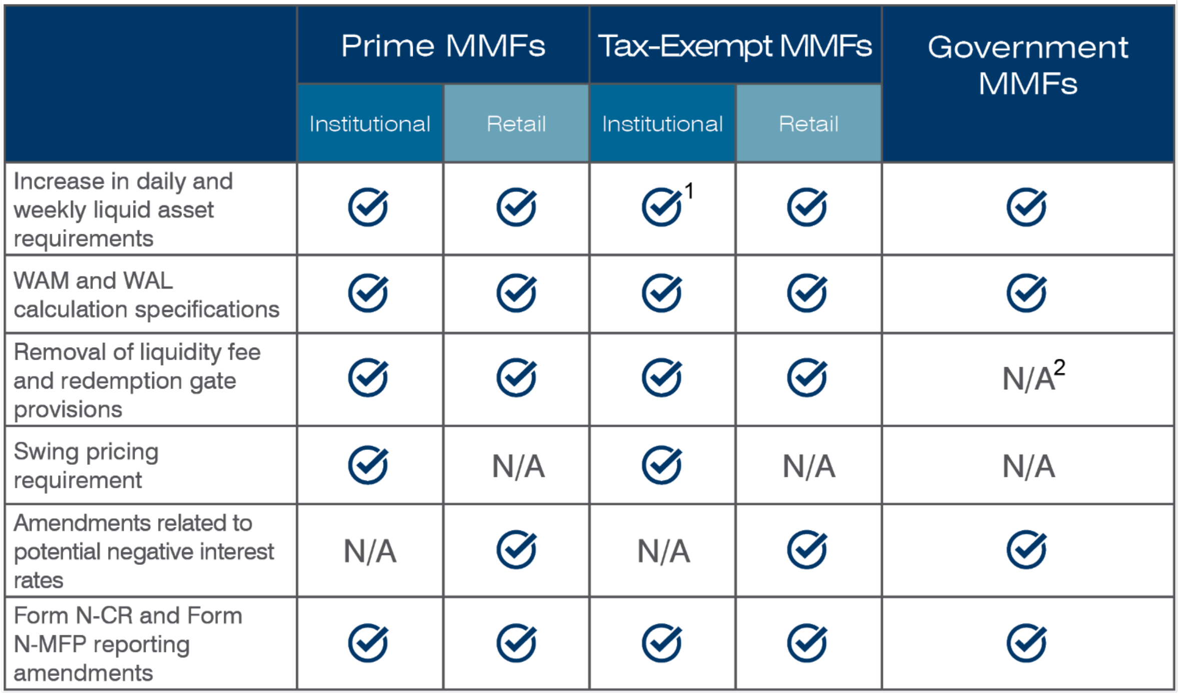
- **Proposed Rule 15Fh-4(c): Chief Compliance Officer Independence.** The SEC is proposing a rule aimed at protecting the independence and objectivity of the chief compliance officer of a security-based swap dealer by preventing the personnel of such security-based swap dealer from taking actions to coerce, mislead or otherwise interfere with their CCO. Rule 15Fh-4(c) would make it unlawful for any officer, director, supervised person or employee of a security-based swap dealer, or any person acting under such person's direction, to directly or indirectly take any action to coerce, manipulate, mislead or fraudulently influence the CCO in the performance of its duties under federal securities law or the rules and regulations thereunder. The SEC provided as an example of unlawful coercion submission of false documentation to the CCO in order to avoid disclosing the build-up of a large security-based swap position that would require public reporting.

Comments on the proposed rules will be due on March 21, 2022. The SEC's proposing release is available here.

## SEC Proposes Significant Money Market Fund Reforms

Seeking to address issues experienced by certain money market funds in March 2020, at the onset of the COVID-19 pandemic, the SEC recently proposed significant and expansive money market fund reforms. The SEC's multi-faceted proposal, approved on December 15, 2021 by a three-to-two vote, would amend Rule 2a-7 under the Investment Company Act of 1940 to, among other things: increase daily and weekly liquid asset requirements for all money market funds (MMFs); modify stress testing requirements; require MMFs to calculate their "dollar-weighted average portfolio maturity" (WAM) and "dollar-weighted average life maturity" (WAL) using the market values of their portfolio securities; remove liquidity fee and redemption gate provisions from Rule 2a-7; and impose a new swing pricing regime for non-government institutional money market funds (i.e., institutional prime and institutional tax-exempt MMFs). The proposed reforms impose certain new requirements on MMF boards of directors, including the independent directors, which are described below.

**Overview - Applicability of Reform Components to MMFs:**



| | Prime MMFs | | Tax-Exempt MMFs | | Government MMFs |
|---|---|---|---|---|---|
| | Institutional | Retail | Institutional | Retail | |
| Increase in daily and weekly liquid asset requirements | ✓ | ✓ | ✓[1] | ✓ | ✓ |
| WAM and WAL calculation specifications | ✓ | ✓ | ✓ | ✓ | ✓ |
| Removal of liquidity fee and redemption gate provisions | ✓ | ✓ | ✓ | ✓ | N/A[2] |
| Swing pricing requirement | ✓ | N/A | ✓ | N/A | N/A |
| Amendments related to potential negative interest rates | N/A | ✓ | N/A | ✓ | ✓ |
| Form N-CR and Form N-MFP reporting amendments | ✓ | ✓ | ✓ | ✓ | ✓ |

- **Increase in Daily and Weekly Liquid Asset Minimums.** In order to provide a more substantial liquidity buffer in the event of rapid redemptions, a MMF's minimum liquid asset requirements would increase from 10% daily liquid assets to 25%, and from 30% weekly liquid assets to 50%.
- *New Board Notification.* The proposal would require notifications to the MMF board upon the occurrence of specific liquidity threshold events. Specifically, a MMF would be required to notify its board when the fund has invested less than 12.5% of its total assets in daily liquid assets or less than 25% of its total assets in weekly liquid assets (i.e., when the fund experiences a greater than 50% decrease in liquidity below at least one of the proposed daily and weekly liquid asset requirements) (a liquidity threshold event).
  - Following a liquidity threshold event, the proposal would require a MMF (i) to notify the board within one business day of the liquidity threshold event and (ii) to provide the board with a brief description of the facts and circumstances that led to the liquidity threshold event within four business days of the event.
  - The proposal does not contemplate any specific action to be taken by the board upon receipt of such notification.
- *Modifications to Liquidity Stress Testing Requirements.* The proposed reforms would eliminate stress testing at the current 10% weekly liquid asset level, and instead, a MMF would be required to determine the minimum level of liquidity it seeks to maintain during stress periods, periodically test its ability to maintain such liquidity, and provide the board with a report on the results of such testing.
- **WAM and WAL Calculation Specifications.** The proposal would require that MMFs calculate WAM and WAL based on the percentage of each security's market value in a fund's portfolio.
  - This reform would prohibit the practice of calculating WAM and WAL using the amortized cost of each portfolio security.
- **Elimination of Liquidity Fees and Redemption Gates.** The provisions of Rule 2a-7 that were added in the 2014 MMF rule amendments to permit liquidity fees and redemption gates (and sometimes require liquidity fees) when a MMF's weekly liquid assets fall below certain thresholds would be removed.
  - The SEC observed that the possibility of fees and/or gates being imposed appeared to contribute to investors' incentives to redeem from prime MMFs in March 2020 as some funds' liquidity levels declined.
- **Imposition of Swing Pricing Requirement for Institutional MMFs**. The proposal would require institutional MMFs to adopt swing pricing procedures to adjust a fund's current NAV per share by a "swing factor" that effectively passes portfolio transaction costs stemming from shareholder redemptions (but not subscriptions) on to the redeeming shareholders, instead of the transaction costs being borne by the fund's remaining shareholders. The swing factor would be applied when the fund has net redemptions during a "pricing period" (i.e., the period between the fund's NAV strikes for shareholder transactions). Additional elements of the swing pricing requirement are summarized in the table below.

| Swing Pricing for Institutional MMFs | |
|---|---|
| Scope: | Institutional prime and institutional tax-exempt money market funds (Institutional MMFs) |
| Purpose: | To have redeeming investors bear the liquidity costs of their redemptions and avoid diluting remaining shareholders |
| Mechanism: | The Institutional MMF's current NAV per share would be adjusted by a "swing factor," which would be expressed as a percentage discount to a fund's NAV.<br>• Specifically, if an Institutional MMF has net redemptions for a pricing period, the fund would adjust its current per-share NAV by a swing factor that incorporates the spread and transaction costs.<br>• If an Institutional MMF has net redemptions for a pricing period that exceed the "market impact threshold"—usually 4% of the fund's NAV divided by the number of pricing periods the fund has in a business day, or such smaller amount of net redemptions as the "swing pricing administrator" determines—the swing factor would also include market impacts. |
| Implementation: | The swing factor would be implemented by a "swing pricing administrator" who must be reasonably segregated from the Institutional MMF's portfolio management and who would make annual reports to the board.<br>• The proposal defines the swing pricing administrator as the fund's investment adviser, officer or officers responsible for administering the swing pricing policies and procedures. |
| Board Requirements: | The fund's board, including a majority of independent directors, would be required to:<br>• Approve the fund's swing pricing policies and procedures;<br>• Designate the swing pricing administrator; and<br>• At least annually, review a written report from the swing pricing administrator describing the adequacy and effectiveness of the swing pricing procedures and their implementation, any material changes to the procedures since the date of the last report, and the administrator's review and assessment of the fund's swing factors and market impact threshold. |
| Recordkeeping Requirement: | • The swing pricing administrator must maintain a written copy of both the swing pricing policies and procedures and the reports provided to the board for six years, the first two being in an easily accessible place. |
| Reporting Requirement: | • Each Institutional MMF would be required to report in its Form N-MFP filing the number of times the fund applied a swing factor over the course of the reporting period, and each swing factor applied. |
| Comparison to Optional Swing Pricing Adopted for Open-End Funds, other than MMFs and ETFs, under Rule 22c-1: | • Unlike swing pricing for open-end funds under Rule 22c-1, the proposed MMF reforms would require Institutional MMFs to apply swing pricing only in periods of net redemptions, and not during periods of net subscriptions.<br>• Consistent with the approach for open-end funds under Rule 22c-1, if the Institutional MMF has multiple share classes, the fund must calculate net redemptions in the aggregate (i.e., not with respect to each share class) when determining whether to apply the swing factor. |

- **Amendments Related to Potential Negative Interest Rates.** Rule 2a-7 currently allows retail MMFs to use amortized cost and penny-rounding to seek to maintain a stable $1.00 NAV, provided that the fund's board believes such pricing fairly reflects the fund's market-based NAV. The SEC's proposing release for the latest MMF reforms acknowledges that Rule 2a-7 currently does not explicitly address how MMFs must operate when interest rates are negative. The proposing release states that if interest rates turn negative, "the board of a stable NAV fund could reasonably require the fund to convert to a floating share price to prevent material dilution or other unfair results to investor or current shareholders."
  - The proposal includes amendments to help assure the operation of government or retail stable NAV funds that have converted to a floating share price due to negative interest rates.
  - *Prohibition of "Reverse Distribution Mechanisms."* The proposal would amend Rule 2a-7 to prohibit MMFs from utilizing a "reverse distribution mechanism" whereby a fund reduces the number of its outstanding shares to maintain a stable NAV despite a negative interest rate environment.
- **Reporting Requirements.** The proposal would amend existing, and impose new, reporting requirements on Forms N-MFP and N-CR, and would also make certain conforming changes to Form N-1A.
  - *Form N-CR*. The proposal would require MMFs to file reports on Form N-CR in a custom structured data format—XML—and make certain other reporting modifications, such as by removing the reporting events that relate to liquidity fees and redemption gates. Liquidity threshold events reported to the board would also need to be reported on Form N-CR.
  - *Form N-MFP*. Proposed amendments to Form N-MFP would include various new disclosure requirements that vary depending on the type of MMF and pertaining to the composition and concentration of the fund's shareholders, portfolio securities sold and imposition of swing pricing during the reporting period.
  - *Form N-1A*. The proposal would require Institutional MMFs to: (i) include a general description of the effects of swing pricing on the fund's annual total returns as a footnote to its risk/return bar chart and table; (ii) include a description of swing pricing in its disclosure regarding procedures for pricing fund shares; and (iii) explain the fund's use of swing pricing, including its meaning, the circumstances under which the fund will use it, and the effects of swing pricing on the fund and investors.
- **Compliance Dates.** The SEC is proposing that removal of the liquidity fees and redemption gates provisions take effect upon the effective date of the final rule. The SEC is proposing the following transition periods, after the effective date of the final rule, for compliance with the remainder of the proposed money market fund rule amendments: (i) a 12-month transition period for the swing pricing requirements, and (ii) a six-month transition period for all other aspects of the proposal.

Comments on the proposal will be due 60 days after publication in the *Federal Register*. The SEC's proposing release is available here.

ENDNOTES

[1] Similar to current Rule 2a-7, a tax-exempt MMF would not be subject to daily liquid asset requirements under the proposed reforms.

[2] Under current Rule 2a-7, a government MMF is permitted, but not required, to implement liquidity fees and/or redemption gates.

## SEC Proposes New Securities Lending Reporting Requirements

On November 18, 2021, the SEC published proposed Rule 10c-1 under the Securities Exchange Act of 1934, which, if adopted, would require lenders of securities to report the material terms of their securities lending transactions to a registered national securities association (RNSA), such as FINRA, which would in turn make public certain information about each securities lending transaction as well as aggregated information about securities on loan and available for loan. The proposed rule is intended to provide investors and other market participants with timely access to pricing and other material information about securities lending transactions and to provide regulators with information to assist in market oversight. The rule was proposed in furtherance of the SEC's mandate under the Dodd-Frank Act to increase transparency in the securities lending market.

Key points from the SEC's proposal include:

- **New Reporting Requirements Would Be Applicable Only to Lenders and Lending Agents.** The reporting requirements under the proposed rule would apply only to lenders of securities. The SEC stated that requiring only one side of the transaction to report would avoid potential double counting of transactions, and that it believes lenders are in a better position than borrowers to provide material information about securities lending transactions. If a lender uses an intermediary such as a bank, clearing agency or broker-dealer for securities lending transactions, the intermediary as lending agent would assume the reporting obligation on behalf of the lender under the proposed rule. The proposed rule also would allow a lender or lending agent to enter into a written agreement with a broker-dealer to serve as its reporting agent.
- **RNSAs and Reporting Agent Requirements.** The proposed rule would require that lenders report the material terms of securities lending transactions to an RNSA in the format and manner required by the RNSA's rules. FINRA currently is the only RNSA, and in the proposing release, the SEC noted that the majority of securities lending transactions are effected through broker-dealers that are members of FINRA. As noted above, the proposed rule would allow a lender (which may not be a member of FINRA) to contract with a broker-dealer (which would be a member of FINRA) to serve as its reporting agent to fulfill its reporting obligations, provided that the reporting agent is provided timely access to the required information. To the extent a lender of securities uses a reporting agent, the proposed rule would require that the reporting agent (1) adopt written policies and procedures to provide the required information to an RNSA consistent with the proposed rule, (2) enter into a written agreement with the RNSA to permit the reporting agent to provide the required information to the RNSA on behalf of the lender, (3) provide the RNSA with a list of the lenders and lending agents for which it serves as reporting agent and update the list on any day the list changes and (4) comply with certain recordkeeping requirements.
- **Required Information and Publication by RNSAs.** The proposed rule would apply to lending activity involving all types of securities (i.e., both equity and non-equity securities). For each securities loan, certain loan-level data would be required to be provided to an RNSA within 15 minutes after a loan is effected or modified, as applicable. This loan-level data would include, among other things, the identity of the securities on loan, the date and time of the loan, the economic terms of the transaction, the collateral provided for the loan, the termination date, if any, and the borrower type, as well as information about certain modifications to the terms of an outstanding loan. The RNSA would then make this information public as soon as practicable. In addition, lenders and lending agents would be required to report to an RNSA certain information about the amount of securities they have available to lend and the total amount of each such security on loan by the end of each business day. The RNSA would make this information available to the public only on an aggregated basis. Lastly, the proposed rule would require certain additional information to be reported to the RNSA along with the loan-level data for purposes of regulatory oversight,

such as the legal names of the parties to securities loans and their roles in the transaction, which would be kept confidential.

- **Requirements Applicable to RNSAs.** Under the proposed rule, the RNSA would be charged with implementing rules regarding the format and manner of collecting and, as applicable, distributing the required information. These rules would, among other things, require the RNSA to retain collected information in a usable standard electronic data format and to make the information available on its website free of charge and without use restrictions for at least five years, and require the RNSA to adopt written policies and procedures to maintain the security and confidentiality of the confidential information it collects. The RNSA would also be able to establish and collect reasonable fees from persons that provide data directly to the RNSA.

The SEC's proposing release is available here. The public comment period ended on January 7, 2022.

## GUIDANCE AND OTHER DEVELOPMENTS

### IRS Provides Temporary Guidance on Stock Distributions by Publicly Offered RICs and REITs

On December 1, 2021, the Internal Revenue Service issued Revenue Procedure 2021-53, which provides temporary guidance regarding the treatment of certain stock distributions by publicly offered regulated investment companies (RICs) and real estate investment trusts (REITs). Revenue Procedure 2021-53 modifies Revenue Procedure 2017-45, which provides a safe harbor under which a publicly offered RIC or REIT may permit shareholders to elect to receive a distribution in stock in lieu of cash, provided, among, other things that the RIC or REIT makes at least 20 percent of the aggregate distribution in cash. (See Vedder Price's publication *Strategies for Funds Facing Liquidity Issues as a Result of the COVID-19 Pandemic*, available here, for additional information on the safe harbor.) Recognizing the need RICs and REITs may have for liquidity as a result of the effects of the ongoing COVID-19 pandemic, the IRS issued Revenue Procedure 2021-53 to reduce temporarily the minimum required aggregate amount of cash that RIC and REIT shareholders receive to not less than 10 percent of the total distribution. Revenue Procedure 2021-53 is effective only with respect to distributions declared by a publicly offered RIC or REIT on or after November 1, 2021 and on or before June 30, 2022.

The IRS previously granted similar temporary relief applicable to distributions declared by publicly offered RICs and REITs between April 1, 2020 and December 31, 2020 pursuant to Revenue Procedure 2020-19.

The full text of Revenue Procedure 2021-53 is available here.

### SEC Staff Statement Highlights Need for Form CRS Disclosure Improvements

On December 17, 2021, the SEC's Standards of Conduct Implementation Committee issued a statement summarizing its observations following a review of Form CRS relationship summaries filed with the SEC by a cross-section of broker-dealers and investment advisers and the firms' compliance with Form CRS requirements.

The Committee's observations identified various problematic disclosures and/or disclosure practices, including the following:

- **Use of Technical Language and/or Inclusion of Disclaimers or Other Impermissible Disclosures.** Some firms used legal jargon and/or highly technical business terms without providing clear explanations. The staff also observed some relationship summaries that included impermissible disclaimers and hedging language.
- **Omission or Modification of Required Information.** Certain firms omitted or modified required disclosures, such as headers, prescribed language or conversation starters—in certain instances in apparent reliance on

the proposed instructions to Form CRS rather than the adopted final instructions.

- **Shortcomings in Descriptions of Relationships and Services; Fees, Costs, Conflicts and Standards of Conduct.** Some relationship summaries failed to adequately describe substantive topics required to be addressed by the form, including monitoring retail investors' investments, the scope of a firm's investment authority, limitations on investment offerings, principal fees and costs, wrap fee program offerings and fees, firm and financial professional compensation arrangements and conflicts of interest.
- **Modification and/or Supplementation of the Disciplinary History Disclosure.** In some relationship summaries, firms omitted or modified the heading or the conversation starters and/or provided extraneous language explaining their response (beyond the permissible yes or no response) to the required disciplinary history disclosure.
- **Issues with Prominently Displaying Relationship Summaries on Firm Websites.** In some instances, the staff was unable to locate a relationship summary on a firm's website or was able to locate the relationship summary only after an extensive search of the firm's website.
- **Use of Marketing Language and/or Vague and Imprecise Boilerplate Explanations.** The staff reviewed some relationship summaries that included marketing language, touted firms' abilities, or used superlatives or similar descriptors. In addition, the staff observed disclosures in some relationship summaries that did not appear to be tailored to the particular firm's services, fees, relationships or conflicts.

The SEC staff encourages firms to familiarize themselves with the specific requirements of Form CRS by reviewing the Form CRS adopting release, the Small Entity Compliance Guide (as applicable) and the staff's Frequently Asked Questions on Form CRS. Additionally, firms can submit interpretive questions to IABDQuestions@sec.gov.

The Committee's statement is available here.

# Enforcement and Litigation Matters

## ENFORCEMENT MATTERS

### Highlights from the SEC Division of Enforcement's 2021 Annual Report

On November 18, 2021, the SEC announced enforcement results stemming from its 2021 fiscal year, which ended on September 30, 2021. The SEC reported 434 new enforcement actions filed in 2021, representing a 7 percent increase over the prior year, and involving new or developing areas of the securities industry, such as crypto, SPACs and Form CRS compliance.

With respect to enforcement matters involving investment advisers, the SEC highlighted several actions in "key priority areas," including the following:

- The SEC charged an adviser for inadequate disclosures and other misstatements and omissions concerning its transfer of top traders to another fund resulting in a $170 million return to harmed investors.
- The SEC charged two advisers and their portfolio managers with misleading investors about risk management practices regarding a mutual fund and several private funds that lost more than $1 billion in two trading days.
- The SEC charged an adviser with fraudulently raising and misappropriating tens of millions of dollars in a private fund.
- The SEC charged a robo-adviser with breaching its fiduciary duties in connection with investments into exchange-traded funds sponsored by an affiliate.
- The SEC charged an adviser for breaching its fiduciary duties in connection with its receipt of revenue sharing payments.

Overall, the SEC obtained judgments and orders for nearly $2.4 billion in disgorgement and more than $1.4 billion in penalties, representing a 33 percent decrease and 33 percent increase, respectively, over amounts ordered in the prior fiscal year. The SEC also reported awards totaling $564 million to 108 whistleblowers—establishing fiscal year 2021 as a record year for whistleblower awards—and noted that its whistleblower program surpassed $1 billion in awards over the life of the program.

The SEC's announcement is available here.

## SEC Settles Charges Against Operating Company for Failure to Evaluate and Disclose Director's Breach of Independence Standards

On January 7, 2022, the SEC settled an administrative proceeding brought against a publicly traded operating company that the SEC alleged violated various provisions of and rules under the Securities Exchange Act of 1934 by failing to evaluate and disclose certain business relationships that caused a purportedly independent director to breach applicable independence standards. In May 2019, the company appointed a new independent director to its board, who was selected to serve as the chair of an independent committee tasked with reviewing strategic alternatives, including a possible sale of the company. In September 2019, the new director was named the chief financial officer of a second public company on whose board and compensation committee the first company's chief executive officer served. This interlocking relationship caused the purportedly independent director to no longer satisfy the NYSE's director independence standards. However, the director continued to be identified as independent in the company's shareholder reports, proxy statements and other SEC reports. The SEC alleged that the company failed to maintain disclosure controls and procedures to identify potential director independence issues and that, as a result, the company made material misstatements and omissions in its public filings. The SEC noted, among other things, that the company did not solicit independence questionnaires from its CEO or the new director before preparing its 2020 proxy statement. In settlement of the charges, without admitting or denying the findings set forth in the SEC's order, the public company agreed to cease and desist from violating applicable provisions of and rules under the Exchange Act and to pay a civil monetary penalty of $325,000.

A copy of the SEC's cease-and-desist order is available here.

# Public Statements, Press Releases and Testimony

### PUBLIC STATEMENTS

## SEC Staff Issues Statement on LIBOR Transition with Key Considerations for Market Participants

On December 7, 2021, the SEC staff issued a statement to remind issuers, investment professionals and other market participants of their obligations related to the LIBOR transition. The publication of non-U.S. dollar-based LIBOR rates was discontinued after December 31, 2021, and the publication of U.S. dollar-based LIBOR rates will cease after June 30, 2023. The Secured Overnight Financing Rate (SOFR) has been identified as the preferred alternative reference rate in place of U.S. dollar-based LIBOR. Among other things, the SEC staff noted that the transition to SOFR may have an impact on recommending to customers LIBOR-linked securities or investment strategies using LIBOR as a benchmark. Furthermore, the SEC staff highlighted several obligations of which broker-dealers, registered investment advisers and funds should be aware with regard to the transition.

With respect to broker-dealers, the SEC staff noted that under Regulation Best Interest (Reg BI), a broker-dealer that recommends to a retail customer LIBOR-linked securities or investment strategies involving those securities must have a reasonable basis, based on considerations of a security's or strategy's risks, rewards and costs, to believe that the recommendation is in the customer's best interest. In this regard, the staff stated that broker-dealers should ensure that LIBOR-linked securities or strategies have robust fallback language in offering documents that clearly defines the replacement reference rate that will take effect upon the discontinuation of LIBOR, and consider the impact that the proposed replacement rate may have on the expected performance of any LIBOR-linked security or strategy.

With respect to registered investment advisers and funds, the SEC staff noted the following:

- Advisers generally should consider whether any advice regarding LIBOR-linked investments and risks related to those investments is consistent with their clients' goals in light of the fiduciary duties advisers owe their clients. This includes considering whether recommended investments or related contracts have robust fallback language to implement an alternative reference rate when LIBOR is discontinued and whether the transition to an alternative reference rate may create economic differences that could cause the investment to depart from a client's strategy or risk tolerance.
- Registered funds, including BDCs, and private fund advisers should be aware of disclosure obligations related to the LIBOR transition. For example, a fund that invests significantly in LIBOR-linked investments may have principal risks related to the discontinuation of LIBOR and the volatility, valuation and liquidity it may have on its portfolio holdings.
- Advisers, funds and fund boards should be aware of valuation risks associated with the discontinuation of LIBOR and the transition to an alternative reference rate as well as the effect these developments may have on valuation inputs and assumptions.
- Advisers should monitor and manage potential conflicts of interest related to the LIBOR transition. For example, an adviser that charges performance fees subject to a hurdle rate tied to LIBOR or an index containing LIBOR-linked securities should consider disclosing that it may be easier to earn the performance fee after the transition to an alternative reference rate.
- Finally, advisers and funds should consider whether they or their key service providers need to make changes to operational processes and IT systems in connection with the LIBOR transition, which could take a significant amount of time to complete.

The SEC staff statement is available here.

## SEC Chair's Remarks Suggest Heightened Regulatory Scrutiny of Private Funds

On November 10, 2021, SEC Chair Gary Gensler delivered remarks at the Institutional Limited Partners Association (ILPA) Summit, outlining his objectives for the SEC's oversight of private funds and signaling potential areas of increased regulatory scrutiny. The topics addressed by Chair Gensler included the following:

- **Fees and Expenses**. Chair Gensler discussed his intention to promote additional transparency around fees and expenses to private fund investors. In contrast to the reductions over time in registered fund fees, he noted that there has not been significant downward movement from the traditional "2 and 20" model for private fund annual management and performance fees. Suggesting that investors may not have sufficient insight to foster competition on fees, Chair Gensler has asked the SEC staff to consider what recommendations the staff could make to bring greater transparency to private fund fee arrangements.
- **Side Letters**. Chair Gensler expressed the view that certain side letter provisions create an uneven playing field among limited partners, particularly with respect to preferred liquidity terms or disclosures. Similarly, he alluded to research in this area suggesting that similar pension plans consistently pay different private equity fees. Thus, he noted that he has tasked his staff with considering recommendations to "level the playing

field", including, notably, whether certain side letter provisions should not be permitted.

- **Performance Metrics**. Chair Gensler also signaled his intention to increase transparency of private fund performance metrics, noting his staff has been asked to consider potential areas for enhancements.
- **Fiduciary Duties and Conflicts of Interest**. Acknowledging that general partners occasionally seek waivers at the state level of their fiduciary duties to investors, Chair Gensler emphasized that an investment adviser to a private fund has a federal fiduciary duty to the fund enforceable under the Investment Advisers Act of 1940, which may not be waived. He also stressed that contract provisions purporting to waive the adviser's federal fiduciary duty are inconsistent with the Advisers Act, regardless of the client's sophistication. He has asked the staff to consider how the SEC can better mitigate the effects of conflicts of interest between general partners, their affiliates and investors, including the potential for prohibitions on certain conflicts and practices.
- **Form PF and the Availability of Private Fund Data to Regulators.** Finally, Chair Gensler noted that he has asked the SEC staff for recommendations to enhance private fund reporting and disclosure through Form PF or other reforms. Recently, on January 26, 2022, the SEC issued proposed changes to Form PF to require current reporting and amend reporting requirements for large private equity fund advisers and large liquidity fund advisers.

A copy of Chair Gensler's remarks to the ILPA is available here.

## Investment Services Group Members

### Chicago

| | |
|---|---|
| Cathy G. O'Kelly, *Co-Chair* | +1 (312) 609 7657 |
| Juan M. Arciniegas | +1 (312) 609 7655 |
| James A. Arpaia | +1 (312) 609 7618 |
| Deborah B. Eades | +1 (312) 609 7661 |
| Renee M. Hardt | +1 (312) 609 7616 |
| Joseph M. Mannon | +1 (312) 609 7883 |
| John S. Marten, *Editor* | +1 (312) 609 7753 |
| Maureen A. Miller | +1 (312) 609 7699 |
| Jacob C. Tiedt, *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 |
| Nathaniel Segal, *Editor* | +1 (312) 609 7747 |
| Adam S. Goldman | +1 (312) 609 7731 |
| Kelly Pendergast Carr | +1 (312) 609 7719 |
| Ryan Hajen | +1 (312) 609 7763 |
| Mark Quade | +1 (312) 609 7515 |
| David W. Soden | +1 (312) 609 7793 |
| Christina V. West | +1 (312) 609 7567 |
| Jake W. Wiesen | +1 (312) 609 7838 |

### New York

| | |
|---|---|
| Wayne M. Aaron | +1 (212) 407 7640 |
| Jeremy I. Senderowicz | +1 (212) 407 7740 |
| Rachel Behar | +1 (212) 407 7641 |
| Laure Sguario | +1 (212) 407 7746 |

### San Francisco

| | |
|---|---|
| Rob Crea | +1 (424) 204 9504 |

### Washington, DC

| | |
|---|---|
| Bruce A. Rosenblum, *Co-Chair* | +1 (202) 312 3379 |
| Marguerite C. Bateman | +1 (202) 312 3033 |
| W. Thomas Conner | +1 (202) 312-3331 |
| Amy Ward Pershkow | +1 (202) 312 3360 |
| Kimberly Karcewski Vargo | +1 (202) 312 3385 |
| John M. Sanders | +1 (202) 312 3332 |

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