Investment Services Regulatory Update

April 2022

Monthly Version

VedderPrice

New Rules, Proposed Rules, Guidance and Alerts

PROPOSED RULES

SEC Proposes Short Sale Data Reporting by Institutional Investment Managers

On February 25, 2022, the SEC proposed a new rule and form requiring certain institutional investment managers to file confidential monthly reports with the SEC regarding short sale data. As proposed, the SEC would then publish certain aggregate information on large short positions related to individual equity securities and net activity during the applicable month. This information is intended to supplement the current short sale transaction information provided by major U.S. stock exchanges and FINRA.

Specifically, proposed Rule 13f-2 under the Securities Exchange Act would require institutional investment managers to file new Form SHO with the SEC confidentially, within 14 calendar days after the end of each calendar month, with regard to each equity security and all accounts over which the manager meets or exceeds one of the thresholds described below. The specific threshold would depend on whether the short position relates to an equity security of a reporting or non-reporting entity (i.e., whether the issuer is required to file reports pursuant to the Exchange Act), as follows:

- With respect to an equity security of a reporting issuer, a manager would file Form SHO to report each "gross short position" over which it and any person under the manager's control has investment discretion collectively that (1) has a value of at least $10 million at the close of any settlement date during the calendar month, or (2) represents a monthly average gross short position as a percentage of shares outstanding in the equity security of at least 2.5%.
- For an equity security of a non-reporting issuer, disclosure would be required of each short position with a value that meets or exceeds $500,000 at the close of any settlement date during the month.

The information an institutional investment manager would report would include:

- the name of the eligible security;
- end of month gross short position information; and
- daily trading activity that affects a manager's reported gross short position for each settlement date during the calendar month reporting period.

A manager would need to determine whether it has a Form SHO filing requirement on a month-by-month basis.

As proposed, one month after the end of each calendar month, the SEC would publish the following aggregate short position information regarding each individual equity security reported by managers on Form SHO:

- the aggregate gross position as of the calendar month's last settlement date;
- the aggregate gross short position's dollar value;
- a summary of the managers' reported hedging information with respect to the reported equity security;
- the percentage of the aggregate gross short position for a reported equity security that is reported as being fully hedged, partially hedged or not hedged; and
- the "net" activity in the reported equity security for each individual settlement date during the calendar month.

Comments on the proposal are due by April 26, 2022.

The SEC's proposing release is available here.

SEC Proposes Significant Changes to Beneficial Ownership Reporting Requirements

On February 10, 2022, the SEC proposed significant amendments to the rules governing beneficial ownership reporting. The SEC's proposed changes seek to modernize reporting on Schedules 13D and 13G by updating filing deadlines, expanding the rule's application to derivative securities, clarifying aggregation concepts and requiring use of structured, machine-readable data language.

Proposed Schedules 13D and 13G Filing Deadlines

The following table compares the current and proposed filing deadlines for initial and amendment filings, as well as proposed adjustments to the SEC's "cut-off" time each business day.

The proposed amendments also provide that only *material* changes—instead of *any* change—to the information previously reported on Schedule 13G will require an amendment.

Reporting of Certain Derivative Securities

The proposed amendments would provide that a holder of a cash-settled derivative security (other than a security-based swap) will be deemed the beneficial owner of the reference equity securities for the purposes of Schedule 13D and 13G filings, provided that the derivative is held with the purpose or effect of changing or influencing the control of the issuer of the reference security. In addition, Item 6 of Schedule 13D would require disclosure of interests in all derivative securities (including cash-settled derivative securities) that use the issuer's security as a reference security.

	Current Schedule 13D	Proposed New Schedule 13D	Current Schedule 13G	Proposed New Schedule 13G
Initial Filing Deadline	10 days	5 days	Qualified Institutional Investors (QIIs) and Exempt Investors: 45 days after calendar year in which beneficial ownership exceeds 5% Passive Investors: 10 days	QIIs and Exempt Investors: 5 days after the month end in which beneficial ownership exceeds 5% Passive Investors: 5 days
Amendment Filing Deadline	Promptly a fter a triggering event	Within one business day after a triggering event	All Schedule 13G Filers: 45 fter calendar-year end in which a triggering event occurs QIIs: 10 days after month end in which a triggering event Passive Investors: Promptly after a triggering event	All Schedule 13G Filers: 5 business days after month-end in which a triggering event occurs QIIs: 5 days after a triggering event Passive Investors: One business day after a triggering event
Filing "Cut-Off" Time	5:30 p.m. ET	10:00 p.m. ET	5:30 p.m. ET	10:00 p.m. ET

Clarification of Aggregation Rules

The proposed amendments would outline circumstances under which two or more persons have formed a "group" such that beneficial ownership must be aggregated for the purpose of Schedule 13D or 13G filings, including "tipper-tippee" relationships where non-public information concerning upcoming Schedule 13D filings precedes the purchase of the issuer's security by another person. The proposed amendments also would expand on exemptions from deemed "group" formation where (i) investors communicate with one another or the issuer without the purpose or effect of influencing control of the issuer and (ii) investors enter into derivative security agreements with financial institutions.

Structured Data Requirement

The proposed amendments would require that Schedule 13D and 13G filings use structured, machine-readable data language.

Comments on the proposed changes to beneficial ownership reporting are due by April 11, 2022. The SEC's proposing release is available here.

SEC Proposes Rule Changes to Shorten Securities Settlement Cycle

On February 9, 2022, the SEC issued a release proposing rule changes to shorten the standard settlement cycle for most broker-dealer transactions from two business days (T+2) to one business day (T+1). The proposed rule changes would also shorten the process of confirming and affirming trade information necessary to prepare a transaction for settlement and add a new requirement for central matching service providers to facilitate the achievement of "straight-through processing," whereby the entire trade process from execution to settlement is automated, obviating the need for manual intervention. Finally, the SEC is seeking comment on challenges associated with and potential paths to achieving a same-day settlement cycle (T+0).

Highlighting recent periods of increased market volatility following the outbreak of the COVID-19 pandemic in March 2020 and the heightened interest in certain "meme" stocks in January 2021, the SEC stated that the proposed amendments are intended to reduce credit, market and liquidity risks in securities transactions faced by market participants. The SEC last shortened the standard settlement cycle from T+3 to T+2 in 2017.

For broker-dealers, the SEC has proposed to amend Rule 15c6-1 under the Securities Exchange Act of 1934 to shorten the standard settlement cycle for most broker-dealer transactions from T+2 to T+1, to repeal the T+4 standard settlement cycle for firm commitment offerings priced after 4:30 p.m. Eastern time, and to amend Rule 15c6-2 under the Exchange Act to prohibit broker-dealers from entering into contracts with institutional customers unless those contracts require the parties to complete allocations, confirmations and affirmations by the end of the trade date (same-day affirmation). In addition, for registered investment advisers, the SEC has proposed to amend Rule 204-2 under the Investment Advisers Act of 1940 to require advisers to make and retain records of confirmations, allocations and affirmations sent to broker-dealers.

In the proposing release, the SEC proposed a compliance date of March 31, 2024 for the transition to T+1 settlement. The SEC stated that comments received regarding the feasibility of same-day settlement would be used to inform any future action to further shorten the settlement cycle beyond T+1.

The SEC's proposed rule is available here. The public comment period will be open through April 11, 2022.

SEC Proposes New Cybersecurity Rules for Investment Advisers and Investment Companies

On February 9, 2022, the Securities and Exchange Commission (the SEC) issued proposed rules 206(4)-9 under the Investment Advisers Act of 1940, as amended

(Advisers Act) and 38a-2 under the Investment Company Act of 1940 (Investment Company Act) (such rules collectively referred to as the 'cybersecurity risk management rules'), to require investment advisers registered under the Advisers Act (advisers) and registered investment companies under the Investment Company Act (funds) to adopt and implement significant new written cybersecurity policies and procedures. At a high level, the proposed rules would require annual reviews, add new disclosure requirements, and add new SEC and investor reporting requirements, among other requirements.

Highlights of the proposed rules include the following:

Adopting policies and procedures. Advisers and funds would be required to adopt and implement written policies and procedures that are reasonably designed to address cybersecurity risks. Recognizing that not all advisers and funds have uniform businesses or technology systems, the proposed rules would give advisers and funds flexibility to tailor such policies to the nature and scope of their business and their individual cybersecurity risks. Specifically, the proposed rules would require the policies and procedures to address certain specific areas, including performance of periodic risk assessments, user security and access, information protection, threat and vulnerability management, and incident response and recovery. Importantly, the proposed rules would provide flexibility for advisers and funds to determine the person(s) responsible for implementation and oversight of the policies, in addition to flexibility to outsource certain cybersecurity responsibilities.

Annual review of policies and procedures. Advisers and funds would be required to, at least annually, review and assess the design and effectiveness of the cybersecurity policies and procedures, including whether they reflect changes in cybersecurity risk over the time period covered by the review, and prepare a written report. At a minimum, the report would describe the annual review, assessment and any control tests performed, document any cybersecurity incidents, and discuss any material changes to the policies and procedures.

Fund board oversight. Proposed rule 38a-2 would require that a fund's board of directors initially approve its policies, written reports on cybersecurity incidents and material changes to policies that would be required to be prepared at least annually.

New recordkeeping requirements. Under the proposed rules, advisers and funds would be subject to enhanced recordkeeping requirements, including, among other items, annual review reports and supporting records, reports of any significant fund cybersecurity incidents and supporting documentation, and records documenting the cybersecurity risk assessment, each from within the preceding five years.

Cybersecurity-related disclosures. The proposed rules would require disclosure of certain cybersecurity risks and incidents to current and prospective investors and clients, including through updates to an adviser's Form ADV Part 2A, a new proposed section of Form ADV for advisers and a fund's registration statements, as applicable.

The proposed rules are subject to change following the public comment period and further review by the SEC.

SEC Proposes Sweeping Amendments to the Advisers Act for Private Fund Advisers

On February 9, 2022, the Securities and Exchange Commission (the SEC) issued proposed rules under the Investment Advisers Act of 1940, as amended (Advisers Act), for investment advisers to private funds registered under the Advisers Act. If adopted, the proposed rules represent significant changes to the rules applicable to private fund advisers, and indicate a continued focus on private funds and their advisers by the SEC.

The proposed rules would require that advisers:
(1) distribute quarterly statements to investors disclosing certain detailed information regarding fees, expenses and performance; (2) obtain annual audits of the financial statements of the private funds they manage, in accordance with generally accepted accounting principles (GAAP) by an independent public accountant, and require such

accountant to notify the SEC of certain material events; (3) in connection with certain adviser-led secondary transactions, obtain and distribute to investors a fairness opinion; and (4) document annual compliance reviews in writing.

In addition, the proposed rules would also contain a set of prohibitions applicable to all investment advisers to private funds—regardless of whether registered with the SEC, exempt from registration, or prohibited from registration. Advisers would be prohibited from:

- charging fees to a portfolio investment for any services the adviser does not, or does not reasonably expect to, provide to the portfolio investment (i.e., accelerated payments);
- charging fees or expenses to a private fund associated with government or regulatory examinations or investigations, and regulatory and compliance fees and expenses of the adviser or its related persons;
- reducing the amount of any 'adviser clawback' (i.e., a return of performance fees by the adviser and/or its affiliates) by the amount of certain taxes;
- seeking reimbursement, indemnification, exculpation, or limitation of liability from a private fund for an adviser's wrongful conduct including but not limited to for breach of fiduciary duty (i.e., hedge clauses);
- charging or allocating fees and expenses related to a portfolio investment on a non-pro rata basis, when multiple other clients of the adviser and its related persons have invested or propose to invest in the portfolio investment;
- borrowing money, securities or other assets, or receiving an extension of credit from a private fund; and
- providing certain types of preferential terms to investors (for example, side letters), including preferential liquidity or enhanced portfolio information, absent certain written disclosures to prospective and current investors.

A detailed analysis of the proposed rules is forthcoming.

Litigation and Enforcement Developments

ENFORCEMENT DEVELOPMENTS

SEC Charges Investment Adviser's Former CIO and Founder in Connection with Fraudulently Overvaluing Assets

On February 17, 2022, the SEC filed a complaint in the U.S. District Court for the Southern District of New York alleging that the former chief investment officer and founder of an SEC-registered investment adviser engaged in a fraudulent scheme to overvalue assets held by a mutual fund and a private fund managed by the adviser by more than $1 billion in an effort to artificially inflate the advisory fees paid by the funds and, as a result, his own personal income. The SEC alleged that from at least 2017 through February 2021, the defendant knowingly inflated the funds' stated valuations in at least four ways: by manipulating computer code use by a third-party pricing service's valuation models; by providing inputs to the pricing service's models that the defendant knew did not match the term sheets for the funds' positions; by selecting valuation models that the defendant knew would not properly value the funds' relevant positions; and by knowingly cherry-picking a key valuation input. The SEC alleged that in March 2020, when faced with market volatility in response to the COVID-19 pandemic, the defendant stepped up the manipulation of the funds' valuations, which attracted hundreds of millions of dollars in additional investments and forestalled investor redemptions, all while some funds with similar investment strategies struggled or failed.

The SEC alleged that the defendant tried to conceal the valuation scheme by sending forged term sheets to the funds' independent auditor, providing the SEC with backdated minutes of valuation meetings that never occurred and altering compliance manuals and private placement memoranda. The SEC alleged that by September 2020, the fraudulent scheme had overvalued the funds by more than $1 billion, and that at times the mutual fund was more than 65 percent overvalued. The SEC alleged that as a result of the funds' overvaluation, the defendant received more than $26 million in profit distributions.

The SEC charged the defendant with violating antifraud and other provisions of the federal securities laws and is seeking permanent injunctive relief, return of allegedly ill-gotten gains and civil penalties. The SEC also is seeking to permanently bar the defendant from serving as a public company officer or director.

In conjunction with this action by the SEC, on February 17, 2022, the U.S. Attorney's Office for the Southern District of New York announced criminal charges against the defendant, and the Commodity Futures Trading Commission (CFTC) filed a civil enforcement action against the defendant related to the alleged overvaluation scheme.

The complaint can be found here. The SEC's press release announcing the charges is available here.

SEC Charges 12 Additional Firms for Failure to Meet Form CRS Obligations

On February 15, 2022, the SEC announced settlements with 12 firms—six investment advisers and six broker-dealers—relating to the alleged failure to (1) file and deliver Form CRS relationship summaries to their retail clients by the required deadline and, in certain cases, (2) include all information necessary to satisfy Form CRS requirements. The SEC's press release noted that a total of forty-two firms have now settled administrative proceedings with the SEC for alleged failures to satisfy Form CRS filing, delivery and/or content requirements since the Form's requirements took effect (June 30, 2020 with respect to prospective and new retail clients and July 30, 2020 with respect to existing retail clients). In the latest batch of settlements, each of the firms agreed—without admitting or denying the SEC's findings—to be censured, to cease and desist from violating the charged provisions and to pay civil penalties ranging from $10,000 to $97,523.

The settlements follow a December 2021 statement issued by the SEC's Standards of Conduct Implementation Committee, 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. (See *SEC Staff Statement Highlights Need for Form CRS Disclosure Improvements*, available here.)

The SEC's press release announcing the settlements is available here.

FINRA Settles Enforcement Proceeding Against Firm's AML Compliance Officer for Alleged Failure to Implement AML Program

The former anti-money-laundering (AML) compliance officer of a large broker-dealer firm recently settled a FINRA enforcement matter in which he personally agreed to pay a $25,000 fine for failing to oversee his employer's AML program. In addition to the fine, the individual was prohibited from associating with any FINRA member for two months from the date of the settlement and agreed to an undertaking to complete ten hours of AML education. This settlement followed an earlier FINRA settlement in 2020 in which the same firm agreed to pay a $38 million fine to settle claims related to its AML program.

As set forth in the FINRA letter of acceptance, waiver and consent related to the settlement, FINRA's allegations against the former AML compliance officer included the following:

- Failure to "meaningfully familiarize" himself with and understand the day-to-day operations and implementation of the firm's AML program;

- Failure to perform a monthly review of at least one of the firm's surveillance reports, as required by the firm's written procedures, and to understand the firm's AML risk profile;
- Failure to supervise the firm's AML analysts;
- Failure to ensure the adequacy of the firm's AML investigations; and
- Failure to file suspicious activity reports (SARs) after learning of suspicious activity from regulators or law enforcement agencies. FINRA specifically indicated that the firm filed only three SARs in response to 37 regulatory inquiries from FINRA and the SEC during a two-year period.

The FINRA letter of acceptance, waiver and consent is available here.

LITIGATION

District Court Rules in Favor of Investor in Closed-End Fund Litigation

On January 14, 2021, certain institutional investors brought an action against a group of closed-end funds organized as Massachusetts business trusts and their trustees seeking rescission of a control share bylaw provision and a declaratory judgment to the effect that the control share bylaw is illegal. The control share bylaw provision in question generally provides that an acquisition of shares that results in a shareholder owning more than 10 percent of a fund's outstanding shares prevents that shareholder from voting shares in excess of 10 percent unless specifically authorized by the affirmative vote of fund's other shareholders. The control share bylaw is intended to operate in a manner similar to control share provisions under state corporate statutes.

Plaintiffs contended that the control share bylaw was inconsistent with Section 18(i) of the Investment Company Act of 1940, which provides that "every share of stock . . . issued by a registered management company . . . shall be a voting stock and have equal voting rights with every other outstanding voting stock . . . ." The defendants presented numerous arguments against the plaintiffs' contention, and in particular noted the staff of the SEC's recission in May 2020 of a 2010 no-action letter (the Boulder letter) setting forth the staff's former view that a closed-end fund opting into a state control share statute would be inconsistent with Section 18(i). On February 17, 2022, the U.S. District Court for the Southern District of New York granted a motion for summary judgment in favor of the plaintiffs on their claims for rescission of the control share bylaw and a declaratory judgment, concluding that the control share bylaw was inconsistent with Section 18(i) of the 1940 Act. In so deciding, the court focused on the plain language of Section 18(i), concluding that what makes a stock "voting" depends on its holder's ability to "*presently* vote the stock," and that a control share bylaw that deprives a shareholder of this ability, even temporarily, renders the stock not a "voting security" under the 1940 Act.

The order was issued under the caption *Saba Capital CEF Opportunities 1, Ltd., et al. v. Nuveen Floating Rate Income Fund, et al.,* No. 21-cv-327. On February 25, 2022, the funds and their trustees filed a notice of their intention to appeal the district court's order.

Investment Services Group Members

Chicago

Joseph M. Mannon, *Co-Chair*........... +1 (312) 609 7883
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
John S. Marten, *Editor*..................... +1 (312) 609 7753
Maureen A. Miller.............................. +1 (312) 609 7699
Nathaniel Segal, *Editor*..................... +1 (312) 609 7747
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
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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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.