Investment Services Regulatory Update

September 2022

Monthly Version

VedderPrice

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GUIDANCE & ALERTS

Bulletin Describes SEC Staff's Expectations Regarding Investment Advisers' and Broker-Dealers' Conflicts of Interest

On August 3, 2022, the SEC staff published a bulletin in question-and-answer format reiterating the standards of conduct for broker-dealers under Regulation Best Interest and for investment advisers under the Advisers Act's fiduciary standard and reminding firms of their obligations to act in the best interest of retail investors and not to place their own interests ahead of those of investors.

Among other things, the SEC staff emphasizes that identifying and addressing conflicts should not be merely a "check-the-box" exercise, but, instead, should entail a "robust, ongoing process that is tailored to each conflict."

While the SEC staff's guidance acknowledges that the specific measures to be taken or factors to be considered by a firm depend on its particular facts and circumstances, including the firm's business model and scope of services, the bulletin includes important reminders regarding the core obligations of firms that engage retail investors and offers insight on the SEC staff's broad view of potential sources of conflicts.

The following is a summary of key points made by the SEC staff in the bulletin.

Identifying and Monitoring for Conflicts

- Notably, the bulletin states unequivocally that all firms and financial professionals have at least some conflicts of interest with their retail investors. This unambiguous position of the SEC staff is coupled with an expansive view of potential sources of conflicts of interest, including various forms of compensation, revenue or other benefits (financial or otherwise). For example, the bulletin cites compensation based on assets gathered and/or products sold, including, but not limited to, receipt of assets under management or engagement fees, commissions, markups, payment for order flow, cash sweep programs, or other sales charges, as well as payments from third parties whether or not related to sales or distribution (for example, sub-accounting or administrative services fees paid by a fund or revenue sharing).

- The SEC staff expresses the view that firms have an ongoing monitoring obligation with respect to conflicts of interest, stating that identifying and addressing conflicts is not a "set it and forget it" exercise. The bulletin states that firms should monitor conflicts over time and assess periodically the adequacy and effectiveness of their policies and procedures.

- As to policies and procedures, the bulletin advises firms to, among other things: (1) define conflicts in a way that is relevant to the firm's business and that enables personnel to understand and identify conflicts; (2) establish a process to identify the types of conflicts that the firm and its financial professionals may encounter and how such conflicts might impact recommendations; (3) ensure there is a process to assess the firm in light of changes—such as new lines of business, products or services or organizational developments—so that any new conflicts of interest are identified; and (4) establish training programs regarding employees' responsibilities with identifying conflicts and bringing any to management's attention.

- The bulletin advises firms to establish a "culture of compliance"—an environment where conflicts are taken seriously and financial professionals feel empowered and encouraged to take an active role in identifying conflicts.

Disclosing Conflicts

- Disclosures should be designed to allow investors to make a more informed decision about a recommendation, and, in the case of advisers, provide informed consent to the conflict of interest—meaning, in the SEC staff's opinion, the disclosures should be specific to each conflict and tailored to the firm's business and compensation structures.

- Disclosures stating that a firm "may" have a conflict when the conflict actually exists are not sufficiently specific to disclose the conflict adequately to retail investors.

- The bulletin provides a list of facts that the SEC staff believes should be disclosed, at a minimum, with respect to a conflict associated with compensation or other benefits, such as the source(s) and scale of compensation for the firm and/or financial professional.

Mitigating and Eliminating Conflicts

- Disclosure of conflicts alone does not satisfy the obligation to act in a retail investor's best interest. In the SEC staff's view, certain conflicts should—and, in some cases, must—be addressed through mitigation. The specific mitigation measures, however, depend on the nature and significance of the incentives provided to the firm or its financial professionals and a firm's business model. Moreover, if conflicts cannot be effectively addressed through mitigation, firms may need to determine whether to eliminate the conflict or refrain from providing advice or recommendations that are influenced by that conflict.

- In discussing generally the circumstances when a particular conflict should be eliminated, the bulletin notes that "[f]irms also may find that there are some conflicts that they are unable to address in a way that will allow the firm or its financial professionals to provide advice or recommendations that are in the retail investor's best interest." As an example of such circumstances, the bulletin refers to a firm's adoption of a compensation or incentive program providing significant benefits or penalties based on its financial professionals' success or failure in meeting certain benchmark, quota, or other performance metrics established by the firm—beyond those that are specifically prohibited under Reg BI. In the SEC staff's view, "the greater the reward to the financial professional for meeting particular thresholds (or conversely, the more severe the consequences for failing to meet them), the greater is the concern whether the incentive program complies with Reg BI and the IA fiduciary standard."

- The bulletin cautions that it would be difficult for a firm to demonstrate compliance with the applicable standard of conduct without documenting the measures it takes to mitigate conflicts of interest, including periodic assessments of the firm's policies and procedures.

Product Menus

- Even if a firm's recommendation or advice is limited to a menu of certain products, the SEC staff believes firms must carefully consider how their product menu choices comply with obligations to act in retail investors' best interest.

- Firms should: (1) evaluate whether providing a limited product menu or otherwise limiting the range of products offered creates a conflict that could incentivize the firm to offer products that place the interests of the firm or its professionals ahead of retail investors' interest; (2) consider establishing product review processes for the products they offer (or that are offered by an affiliate) —including, for example, evaluating the use of "preferred lists," identifying and mitigating the conflicts of interest associated with the product, such as payments for shelf space, or restricting the retail investors to whom certain products may be recommended; and (3) identify and disclose any material limitations placed on the recommended securities or strategies and any conflicts of interest associated therewith.

The SEC staff bulletin is available here.

PROPOSED RULES

SEC and CFTC Propose Amendments to Form PF for Private Fund Reporting

On August 10, 2022, the SEC and the Commodity Futures Trading Commission jointly issued proposed amendments to Form PF, a form that requires registered investment advisers to private funds to report confidentially certain information about the funds' operations and investment strategies. An adviser is required to file Form PF if the adviser is registered with the SEC, manages one or more private funds and has at least $150 million in private fund assets under management. The amendments are designed to enhance the Financial Stability Oversight Council's risk monitoring as well as the SEC's and CFTC's regulatory oversight and investor protection efforts in the private fund industry.

The proposed amendments to Form PF include the following:

- The proposed amendments would require enhanced reporting by large hedge fund advisers on qualifying hedge funds (i.e., those with a net asset value of at least $500 million). The enhanced reporting would cover investment exposure, borrowing and counterparty exposure, market factor effects, currency exposure, turnover, country and industry exposure, central clearing counterparty reporting, risk metrics, investment performance by strategy, portfolio correlation, portfolio liquidity and financing liquidity.

- Form PF requires advisers to report identifying information about themselves and the funds they manage. The proposed amendments would expand the information an adviser provides to include legal entity identifiers, assets under management, explanations of assumptions made in Form PF reporting, fund type, withdrawal and redemption rights, gross asset value and net asset value, inflows and outflows, base currency, borrowings and types of creditors, fair value hierarchy, beneficial ownership and fund performance.

- The proposed amendments would require advisers to report more detailed information on hedge fund investment strategies, counterparty exposures and trading and clearing mechanisms and would remove certain duplicative questions from Form PF.

- Form PF currently allows an adviser to report complex structures in the aggregate or separately as long as the reporting is done consistently throughout the Form. The proposed amendments would require advisers to report each component of a master-feeder arrangement and parallel fund structure separately in most situations.

- Form PF currently requires private fund advisers with at least $1.5 billion in hedge fund assets under management to report certain additional information regarding the funds they manage on an aggregate basis. The proposed amendments would remove this aggregate reporting.

Comments on the proposal are due on October 11, 2022.

The proposing release is available here, a related fact sheet is available here, and a related press release is available here.

NEW RULES

CFTC Amends Clearing Requirement for Interest Rate Swaps

On August 12, 2022, the Commodity Futures Trading Commission issued a final rule modifying its clearing requirement for interest rate swaps. The final rule updates the types of interest rate swaps required to be submitted to a registered derivatives clearinghouse for mandatory clearing by eliminating the requirements to clear interest rate swaps referencing the London Interbank Offered Rate (LIBOR) and certain other interbank offered rates (IBORs) and imposing mandatory clearing for overnight index swaps referencing certain alternative reference rates, such as the Secured Overnight Funding Rate (SOFR).

Under the final rule, effective as of:

September 23, 2022:

- mandatory clearing will no longer be applicable to GBP LIBOR,[1] CHF LIBOR,[2] JPY LIBOR,[3] and EONIA[4] in each of fixed-to-floating swap, basis swap, forward rate agreement (FRA)[5] and overnight index swap classes;

- overnight index swaps referencing SARON,[6] TONA[7] (each with range of 7 days to 30 years) and ESTR[8] (7 days to 3 years) are subject to mandatory clearing;

- the termination date range for SONIA[9] overnight index swaps is expanded to 50 years;

October 31, 2022:

- overnight index swaps referencing SOFR (7 days to 50 years) and SORA[10] (7 days to 10 years) are required to be cleared;

July 1, 2023:

- mandatory clearing is no longer applicable for swaps referencing USD LIBOR and SOR-VWAP[11] in fixed-to-floating swap, basis swap, and FRA classes.

In recent years, regulators have been urging market participants to accelerate their adoption of USD SOFR and other replacement risk-free rates and to cease entering into new swaps referencing LIBOR and other IBORs. As this phaseout continues, liquidity has shifted away from IBOR swaps and into overnight index swaps referencing the risk-free rates. In light of this shift, the CFTC has determined that the interest rate swap clearing requirements must be modified to address the cessation (or loss of representativeness) of various IBORs that have been used as reference rates and the market's adoption of swaps referencing the risk-free rates.

CFTC Chairman Rostin Behnam called the final rule an "important milestone" in the transition away from LIBOR and other IBORs, noting the importance of legal certainty and regulatory transparency in promoting financial stability, mitigating systemic risk and ensuring cross-border harmonization in the interest rate swap market.

The final rule is available here.

[1] GBP LIBOR refers to the British pound sterling LIBOR interest rate.

[2] CHF LIBOR refers to the Swiss franc LIBOR interest rate.

[3] JPY LIBOR refers to the Japanese yen LIBOR interest rate.

[4] EONIA refers to the Euro Overnight Index Average, which is computed as a weighted average of all overnight unsecured lending transactions in the interbank market undertaken in the European Union and European Free Trade Association countries.

[5] A forward rate agreement is a cash for difference derivative contract between two parties, benchmarked against an interest rate index.

[6] SARON refers to the Swiss Average Rate Overnight, representing the overnight interest rate of the secured money market for Swiss francs. SARON is published by SIX Swiss Exchange, Switzerland's principal stock exchange. SARON is an alternative to CHF LIBOR.

[7] TONA refers to the Tokyo Overnight Average Rate, an interest rate benchmark that is administered and published by the Bank of Japan. It is a measure of the cost of borrowing in the Japanese yen unsecured overnight money market and is the near risk-free rate for Japanese yen markets. TONA is an alternative to JPY LIBOR.

[8] ESTR refers to the Euro Short-Term Rate, an interest rate benchmark that reflects the overnight borrowing costs of banks within the eurozone. The rate is calculated and published by the European Central Bank. ESTR is an alternative to EONIA.

[9] SONIA refers to the Sterling Overnight Index Average, an interest rate published by the Bank of England. SONIA is an alternative to GBP LIBOR.

[10] SORA refers to the Singapore Overnight Rate Average, the volume-weighted average rate of borrowing transactions in the unsecured overnight interbank SGD cash market in Singapore. SORA is administered by the Monetary Authority of Singapore.

[11] SOR refers to the Singapore Swap Offer Rate. SORA has been identified as the alternative interest rate benchmark to SOR.

OTHER DEVELOPMENTS

PCAOB Signs Statement of Protocol on Inspections and Investigations of China- and Hong Kong-Based Audit Firms

On August 26, 2022, the Public Company Accounting Oversight Board (PCAOB) signed a Statement of Protocol with the China Securities Regulatory Commission and the Ministry of Finance of the People's Republic of China (PRC) that serves as a first step toward permitting the PCAOB to conduct inspections and investigations of China- and Hong Kong-based audit firms in a manner consistent with U.S. law.

The Holding Foreign Companies Accountable Act (HFCA Act), an amendment to the Sarbanes-Oxley Act of 2002, was signed into law on December 18, 2020 to address concerns over audit inspections of China-based companies trading in the United States. Specifically, the HFCA Act requires the SEC to identify all issuers subject to the periodic reporting requirements of the Securities Exchange Act of 1934 whose audited financial reports are prepared by an accounting firm that is located in a foreign jurisdiction and that the PCAOB is unable to inspect due to a position taken by an authority in that jurisdiction. If the PCAOB is unable to inspect the issuer's auditor for three consecutive years, the issuer will be prohibited from having its securities listed for trading on a U.S. exchange or otherwise traded in over-the-counter markets subject to the jurisdiction of the SEC.

The HFCA Act requires the PCAOB to determine whether authorities in a foreign jurisdiction have taken positions that prevent the PCAOB from inspecting or investigating "completely" PCAOB-registered public accounting firms in that jurisdiction. More than 50 foreign jurisdictions currently comply with PCAOB inspection requirements. However, in 2021 the PCAOB determined that PRC authorities had taken positions that would prevent the PCAOB from inspecting and investigating completely audit firms in China and Hong Kong.

Pursuant to the Statement of Protocol, the PCAOB and the PRC have created a framework that may allow for compliance with the HFCA Act, which could allow approximately 200 China-based issuers to avoid being delisted in the United States. The PCAOB will reassess its determination relating to China and Hong Kong before the end of 2022. The PCAOB intends to have inspectors conducting on-site inspections and investigations of audit firms in China and Hong Kong by mid-September 2022 and will base its determination on the ability of its inspectors to obtain full and timely access to information as required by U.S. law.

The SEC's fact sheet pertaining to the Statement of Protocol is available here. The PCAOB's fact sheet is available here. A related statement from SEC Chair Gary Gensler is available here.

Litigation and Enforcement Proceedings

LITIGATION

District Court Issues Order Granting Great-West's Motion for Sanctions

The U.S. District Court for the District of Colorado issued a judgment in favor of Great-West Capital Management, LLC and Great-West Life & Annuity Insurance Co. (together, Great-West) in a Section 36(b) excessive fee case on August 7, 2020. In the wake of trial, both the plaintiffs and Great-West sought sanctions against the other pursuant to 28 U.S.C. § 1927, under which "[a]ny attorney … who so multiplies proceedings in any case unreasonably and vexatiously … may be required by the court to satisfy personally the excess costs, expenses, and attorneys' fees reasonably incurred because of such conduct." On September 28, 2020, the District Court granted Great-West's motion for sanctions, but did not issue a final award.

On August 16, 2022, the District Court issued an order providing that Great-West is entitled to a total of $1.5 million in fees and related expenses against the two law firms that represented the plaintiffs in the action.

Plaintiffs' counsel challenged Great-West's fee request, contending that the attorneys' fees being sought were excessive, that expert witness fees are not awardable under applicable law and that the expert witness fees being sought were excessive. The District Court rejected those arguments. In concluding that the rates charged and number of hours spent by counsel for Great-West were reasonable, the District Court noted Great-West's counter-arguments that the plaintiffs sought tens of millions of dollars in damages, "challenged important facets of [Great-West's] business," and made claims that would harm Great-West's reputation if successful. The District Court agreed with the assertion that the time spent on the trial and post-trial proceedings by defense counsel was reasonable, noting that it was a "high-stakes case," and that Great-West's victory was "the product of a well-prepared defense team and a well-tried defense case." The District Court disagreed with plaintiffs' counsel's contentions that the expert witness fees are not awardable under 28 U.S.C. § 1927. Despite the absence of any binding Tenth Circuit authority on the subject, the District Court noted that allowing Great-West to recover expert fees would align with the purpose of that statute, which is to compensate victims of abusive litigation practices. The District Court did not address plaintiffs' counsel's contention that expert fees in the case were excessive because the District Court had previously capped the total amount available at $1.5 million.

The District Court found that both firms that provided representation to the plaintiffs should be sanctioned. The District Court stated that there was "no basis for assigning more fault to one firm over the other," and that both firms were responsible for "unreasonably prolonging the litigation."

In conclusion, the District Court found that Great-West was entitled to an award of $1,403,452.87 in attorneys' fees and $96,547.13 in expert witness fees and related expenses. Fees were awarded jointly and severally against both law firms that represented plaintiffs.

The order was issued under the caption *Obeslo et al. v. Great-West Capital Management, LLC*, No. 1:16-cv-00230-CMA-SKC.

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Investment Services Group

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