

SEC Brings First Liquidity Rule Enforcement Action

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On May 5, 2023, the SEC announced its first enforcement actions under Rule 22e-4 under the Investment Company Act of 1940, the SEC's liquidity rule, specifically in the form of a lawsuit filed in federal court and a settled administrative proceeding—both of which stem from the same underlying violations of the rule by a registered mutual fund. These actions provide important insight into the SEC's commitment to enforcing new rules, and also send a broader message about board oversight responsibilities.

The SEC's Allegations

According to the SEC's complaint filed on May 5, 2023 in the U.S. District Court for the Northern District of New York, between June 1, 2019, which was the compliance date for relevant aspects of the liquidity rule for smaller entities such as the fund in question, and at least June 16, 2020, approximately 21% to more than 26% of the fund's net assets were invested in shares of a private medical device company. The SEC stated that the shares were not listed on any securities exchange or traded in any over-the-counter market and bore additional sale restrictions imposed by the subscription agreements pursuant to which they were acquired and by the issuing company's operating agreement. The fund's shareholder reports and financial statements identified the shares as illiquid and indicated that market quotations were not readily available for the shares both before and after the effective date of the liquidity rule. However, the securities were classified as "less liquid" for purposes of the liquidity rule. The SEC alleged that during this time, the fund's president (who also served as the fund's portfolio manager) and its chief compliance officer, chief financial officer, vice president and treasurer, as well as its two independent trustees (by virtue of their service on the valuation and audit committees), were aware of the illiquid nature of the shares.

The SEC alleged that, in the period leading up to the compliance date for the liquidity rule, both the fund's external auditors and the outside attorney serving as fund counsel expressed concerns about the fund's concentration in the restricted shares and the impending need to comply with the liquidity rule. Additionally, the complaint indicates that the fund's investment in the restricted shares had been subject to scrutiny by the staff of the SEC's Division of Investment Management, who in connection with reviews of the fund's public disclosure had raised questions about the investment that remained unresolved as of the liquidity rule's compliance date.

The SEC's complaint documents a series of correspondence in May and June of 2019 during which the fund's trustees, officers and counsel discussed the provisions of the fund's liquidity risk management program and the classification of the shares in question. Of note, the SEC alleged that the adviser, as the administrator of the fund's liquidity risk management program, and the two fund officers responsible for implementing the program, against the advice of fund counsel and the view of the fund's external auditors, determined to classify the restricted shares as "less liquid investments" rather than "illiquid investments" under the liquidity rule and, accordingly, did not file a Form N-LIQUID with the SEC to indicate that the fund held more than 15% of its assets in illiquid investments. The SEC alleged that the fund's trustees allowed the fund to make such classification and failed to exercise reasonable oversight. According to the SEC's complaint, fund counsel resigned during the fund's quarterly board meeting on June 14, 2019. The SEC alleged that there was no discussion of the liquidity classification of the shares at the meeting.

The SEC's complaint discusses deliberations by the fund's trustees and officers at subsequent board meetings in 2019 and early 2020 concerning the liquidity classification of the restricted shares. The complaint indicates that the fund hired new external counsel by September 2019, and that this counsel advised the fund in February 2020 that the restricted shares should be classified as illiquid investments. The complaint also indicates that the fund's auditors resigned in April 2020 due to concerns

about the valuation of the fund's restricted shares, in addition to a separate material weakness in the fund's internal controls relative to the performance of asset diversification tests under the Internal Revenue Code of 1986, and that the auditors cited the fund's refusal to follow counsel's advice regarding the liquidity classification of the restricted shares as an additional consideration in their decision to resign.

According to the SEC's complaint, in May or June of 2020, upon the advice of counsel, the fund's investment adviser determined to classify the restricted shares as illiquid investments and to file a Form N-LIQUID with the SEC. The SEC alleged that on June 9, 2020, the fund's interested trustee informed the SEC staff that the resignation of the fund's auditors would prevent the fund from timely filing its annual shareholder report, that the fund was reclassifying the restricted shares as illiquid securities and that fund management was considering winding down the fund. The complaint indicates that the fund filed a Form N-LIQUID on June 19, 2020 that indicated the fund exceeded the 15% threshold on illiquid investments on February 21, 2020 and that approximately 24% of the fund's assets were invested in illiquid investments at that time. The complaint indicates that on August 28, 2020, the fund's board authorized the liquidation of the fund and that the fund made a liquidating distribution to shareholders on September 8, 2020. The SEC stated that, in connection with the liquidation, the restricted shares were transferred to a liquidating trust, where they remained as of May 5, 2023, and that as of that date no distribution had been made to shareholders from the liquidating trust.

The Enforcement Actions

The SEC filed a lawsuit in the U.S. District Court for the Northern District of New York against the fund's investment adviser, the fund's two independent trustees and the two fund officers responsible for implementing the fund's liquidity risk management program. All defendants were charged with aiding and abetting the fund's violations of the liquidity rule, and the adviser and officers were also charged with aiding and abetting the fund's violations of Rule 30b1-10 under the Investment Company Act. The SEC is seeking to impose liability pursuant to Section 48(b) of the Investment Company Act, under which any person who knowingly or recklessly provides substantial assistance to another person in violation of the Investment Company Act, or any rule or regulation thereunder, may in an action brought by the SEC be deemed to be in violation of that provision to the same extent as the primary violator. With respect to the independent trustees, the SEC's complaint alleges that they, "through their oversight failure, substantially assisted the Fund's classification of the [restricted shares] as 'less liquid,'" that they "knew or recklessly disregarded that the [restricted shares] were 'illiquid' within the meaning of the Liquidity Rule, and that there was no reasonable basis supporting a 'less liquid' classification." The complaint further alleges that the fund's independent trustees violated their duties and responsibilities to the fund by "failing to exercise reasonable oversight over the Fund's [liquidity risk management program]." The SEC is seeking to permanently enjoin the adviser and the named fund officers from aiding and abetting future violations of Rule 22e-4(b)(1) and Rule 30b1-10 and the independent trustees from aiding and abetting violations of Rule 22e-4(b)(1), and is seeking an unspecified amount of civil monetary penalties against all defendants.

The SEC simultaneously announced a settled administrative proceeding against the fund's interested trustee. Without admitting or denying the allegations against him, the interested trustee agreed to cease and desist from committing or causing future violations of the liquidity rule, to be suspended from certain industry roles for six months, and to pay a \$20,000 civil money penalty.

Key Takeaways

These enforcement actions demonstrate the SEC's commitment to enforcing its new rules, including with respect to conduct that takes place in the immediate wake of the compliance dates for new rules. However, it remains to be seen whether these enforcement actions were a one-off response to the particularly egregious conduct alleged by the SEC or a sign of more enforcement actions to come relating to the liquidity rule or other recently adopted rules.

These enforcement actions also demonstrate the SEC's commitment to holding fund board members accountable for compliance with rules such as the liquidity rule. In the SEC's press release announcing the enforcement actions, Sheldon L. Pollock, Associate Regional Director in the SEC's New York Regional Office, stated: "Trustees must exercise oversight on behalf of shareholder interests, and the Commission will hold trustees accountable when they fail to fulfill the most basic requirements under the applicable rules." It is worth noting that the SEC is seeking to impose liability on the independent trustees in this case while also specifically alleging that the fund's investment adviser and officers failed to report to the trustees that the fund held illiquid investments exceeding 15% of its net assets.

The enforcement action against the independent trustees serves as a cautionary tale of board oversight responsibilities that transcends the scope of the liquidity rule. As alleged by the SEC, the independent trustees were aware of facts that made the restricted shares illiquid based on information they received as members of the valuation and audit committees, they were aware

that fund counsel resigned because of the “less liquid” classification and they were aware that the fund’s auditor considered the shares to be illiquid, and yet they still allowed the fund to classify the shares as “less liquid.” They also were allegedly aware that new fund counsel advised the fund to reconsider the classification of the restricted shares and that the fund’s external auditors subsequently resigned, in part because of the fund’s failure to follow counsel’s advice on this matter. The enforcement action reminds independent board members of the importance of providing active, effective oversight rather than simply deferring to management when they have reason to believe, or have been advised by independent experts, that something is not right.

Finally, it is important to note that the SEC is pursuing liability against the defendants, including the independent trustees, for aiding and abetting the fund’s violations of the liquidity rule under Section 48(b) of the Investment Company Act—a rare use of this provision by the SEC. The liquidity rule does not impose specific requirements on the board regarding technical compliance with the rule. However, here the SEC has alleged that the independent board members aided and abetted the fund’s violation when they knew the fund was in breach but failed to take action.

The SEC’s complaint is available [here](#). A copy of the order relating to the settled administrative proceeding involving the fund’s interested trustee is available [here](#). A copy of the SEC’s press release announcing these matters is available [here](#).

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