Investment Services Regulatory Update

August 2023

Monthly Version

VedderPrice

New Rules, Proposed Rules, Guidance and Alerts

NEW RULES

SEC Adopts Significant Money Market Fund Reforms and Amended Form PF Reporting Requirements for Private Liquidity Fund Advisers

On July 12, 2023, in a 3-2 vote, the SEC adopted amendments to Rule 2a-7 under the Investment Company Act of 1940, representing the SEC's latest reforms of the rules governing money market funds in its effort to improve their resiliency and ability to manage significant investor redemptions during market stress events.

Key elements of the final rule include:

- **Increased Minimum Daily and Weekly Liquidity Requirements; Board Reporting of Liquidity Threshold Events**. The amendments increase the minimum daily and weekly liquid asset requirements to 25% (up from 10%) and 50% (up from 30%), respectively, of total assets. The amendments also require a fund to notify its board of directors when the fund's liquidity falls to less than half of the required levels—i.e., when the fund has invested less than 12.5% of its total assets in daily liquid assets or less than 15% of its total assets in weekly liquid assets—a circumstance referred to as a "liquidity threshold event." A fund will now be required to notify the board within one business day of a liquidity threshold event and to provide the board with a brief description of the facts and circumstances that led to the liquidity threshold event within four business days after its occurrence. Similar to these board notification requirements, the SEC adopted a requirement that funds file reports on Form N-CR upon a liquidity threshold event.

- **Removal of Redemption Gates from Rule 2a-7**. The amendments remove money market funds' ability to temporarily suspend investor redemptions (i.e., impose a "gate") under Rule 2a-7. Money market funds will continue to be able to impose permanent gates to facilitate an orderly liquidation of a fund pursuant to Rule 22e-3.

- **Mandatory Liquidity Fees for Institutional Prime and Institutional Tax-Exempt Money Market Funds**. The SEC adopted a mandatory liquidity fee framework for institutional prime and institutional tax-exempt money market funds—a notable change from the SEC's proposed swing pricing requirement. This approach effectively imposes the cost of depleting a fund's liquidity on redeeming investors in stressed market conditions and when net redemptions are sizeable. Specifically, institutional prime and institutional tax-exempt money market funds will be subject to a mandatory liquidity fee when net redemptions exceed 5% of net assets. The amount of the mandatory liquidity fee must represent a good faith estimate, supported by data, of the costs the fund would incur if it sold a pro rata amount of each security in its portfolio (i.e., "vertical slice") to satisfy the amount of net redemptions. However, funds will not be required to impose a fee when liquidity costs are less than one basis point. The final rule permits funds to use a lower net redemption threshold for imposing a fee as the board (or its delegate, as addressed further below) determines.

- **Discretionary Liquidity Fees for Non-Government Money Market Funds**. The amendments allow any non-government money market fund to impose a discretionary liquidity fee if the fund's board determines a fee is in the fund's best interest.

- **Removal of Linkage between Weekly Liquid Assets and Liquidity Fees; Reporting Amendments**. Under the SEC's new liquidity fee framework, the amendments remove the tie between a money market fund's weekly liquid asset levels and liquidity fees, for both mandatory and discretionary liquidity fees. This change seeks "to avoid predictable triggers that may incentivize investors to preemptively redeem to avoid incurring fees." In connection with the new liquidity fee framework, the SEC is amending Form N-MFP to require that money market funds report whether they applied a liquidity fee during the reporting period and, if so, information about each liquidity fee applied, including the date, the type of fee, and the amount.

- **Board Delegation of Liquidity Fee Administration**. Importantly, the amendments allow a money market fund's board to delegate responsibility for administering a liquidity fee to the fund's investment adviser or officers, subject to written guidelines established and reviewed by the board and ongoing board oversight. The current rule does not permit a board to delegate its responsibility for liquidity fee determinations. The SEC's adopting release states that the written guidelines generally should specify the manner in which the delegate is to act with respect to any discretionary aspect of the liquidity fee mechanism (e.g., whether the fund will apply a fee to a shareholder based on the shareholder's gross or net redemption activity for the relevant day). The board will also need to periodically review the delegate's liquidity fee determinations.

- **Option to Use RDM in Negative Interest Rate Environment**. If negative interest rates result in a negative gross yield, a retail or government money market fund that seeks to maintain a stable net asset value may convert to a floating share price, as the current rule already permits. The amendments will also permit a stable NAV fund to reduce the number of its shares outstanding to maintain a stable NAV per share in the event of negative interest rates, subject to certain board determinations and disclosures to investors. This new option is referred to as "share cancellation," "reverse distribution mechanism," or "RDM."

- **Amendments to Form PF**. The SEC is also amending Section 3 of Form PF, the confidential reporting form for certain SEC-registered investment advisers to private funds, to require additional information regarding the liquidity funds they advise. These private funds seek to maintain a stable NAV (or minimize fluctuations in their NAVs) and thus are similar in certain respects to money market funds. The amendments will require certain information regarding asset turnover, liquidity management and secondary market activities, subscriptions and redemptions, and ownership type and concentration.

Compliance Dates

The rule amendments will be effective October 2, 2023, and compliance with the reformed requirements is staggered over a 12-month period, as indicated below.

- October 2, 2023: removal of redemption gate provisions.
- April 2, 2024: increased minimum liquidity requirements, discretionary liquidity fee.
- June 11, 2024: amendments to Forms N-MFP, N-CR, and PF.
- October 2, 2024: mandatory liquidity fee.

The SEC's adopting release is available here, and the SEC's corresponding fact sheet is available here.

PROPOSED RULES

SEC Proposes Amendments to the Internet Adviser Exemption

On July 26, 2023, the SEC issued proposed rules under the Investment Advisers Act of 1940 to narrow the types of smaller investment advisers that can register with the SEC in reliance on the Internet adviser exemption. Currently, an investment adviser with less than $25 million in assets under management that would ordinarily be too small to register with the SEC may register so long as it provides investment advice to clients exclusively through an interactive website and engages in appropriate recordkeeping. An adviser also may provide investment advice to fewer than 15 clients through other means during the preceding 12 months. The amendments are designed to modernize the exemption and address investment advisers that rely on the exemption but continue to provide non-Internet-based advice through adviser personnel.

The amendments would:

- Clarify that Internet investment advisers relying on the exemption must have an "operational" interactive website, which would include mobile applications, at all times that it is relying on the exemption;

- Require that an Internet investment adviser provide only "digital investment advisory service," i.e., investment advice to clients generated by the operational interactive website's software-based models, algorithms or applications based on personal information clients supply through the operational interactive website;

- Eliminate the *de minimis* 15-client exception so that the Internet investment adviser must provide investment advice to all clients solely through the interactive website; and

- Require a representation on Form ADV that, among other things, an Internet investment adviser relying on the exemption has an operational website.

Comments on the proposal are due by October 2, 2023.

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

SEC Proposes New Requirements to Address Conflicts of Interest in the Use of Artificial Intelligence and Similar Technologies

On July 26, 2023, the SEC issued proposed rules under the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940 to address conflicts of interest that the SEC believes are associated with the use by broker-dealers and investment advisers of predictive data analytics (PDA) and PDA-like technologies, such as artificial intelligence (AI), in investor interactions. The proposed rules seek to prevent firms from using these technologies to influence investor behavior to the investor's detriment and the benefit of the firm.

Key elements of the proposal are summarized below.

- **Scope**. The proposed rules would apply to all broker-dealers and investment advisers registered, or required to be registered, with the SEC, and would apply only when a firm uses a covered technology in an investor interaction. For broker-dealers, an "investor" would include prospective and current retail investors that are natural persons (or their legal representatives); for investment advisers, an "investor" would include prospective and current clients and prospective and current investors in a pooled investment vehicle advised by the firm. An "investor interaction" would encompass a firm's engagement or communication with an investor, including by exercising discretion with respect to an investor's account, providing information to an investor or soliciting an investor.

- **Covered Technology and Uses**. "Covered technology" under the proposed rules would include a firm's use of analytical, technological or computational functions; algorithms, models, correlation matrices; or similar methods or processes that optimize for, predict, guide, forecast or direct an investor's investment-related behaviors or outcomes. This definition is designed to cover a broad range of technologies, such as AI, machine learning, deep learning, neural networks, natural language processing (NLP) and large language models (including generative pre-trained transformers (GPT)), as well as other technologies that make use of historical or real-time data, lookup tables or correlation matrices. In addition, the proposed rules are intended to capture different use cases for these technologies, including their use in providing investment advice or recommendations and their use in digital engagement practices intended to influence investment-related behaviors or outcomes from investors, such as behavioral prompts, differential marketing, gamification features and other practices. A firm's use of a covered technology would also encompass both direct uses (i.e., an investor directly interfacing with the technology) and indirect uses (i.e., a firm using a technology and communicating the information obtained with that technology to an investor).

  Covered technology would not include: (1) technologies designed solely to inform investors (e.g., a website describing the investor's account balance and past performance); (2) technologies used to make predictions not related to affecting an investment-related behavior or outcome (e.g., whether an investor would be approved for a credit card issued by an affiliate); and (3) technologies used to assist with basic customer service support (e.g., a chatbot used only for this function).

- **Requirements**. Firms subject to the proposed rules would be required to (1) evaluate any use or reasonably foreseeable potential use of a covered technology in any investor interaction to identify any conflicts of interest; (2) determine whether any identified conflict of interest would place the interest of the firm or its associated persons ahead of the interests of investors; and (3) eliminate, or neutralize the effect of, those conflicts of interests promptly after the firm determines, or reasonably should have determined, that the conflict of interest would place the interest of the firm or its associated persons ahead of the interests of investors.

  For purposes of requirement (1) above, a conflict of interest would exist when a firm uses a covered technology that takes into consideration an interest of the firm or its associated persons. In its evaluation of a covered technology, a firm would also be required to test the technology prior to implementation or material modification, and periodically thereafter, to identify any conflicts of interest. For purposes of requirement (3) above, conflicts of interest that exist solely because a firm seeks to open a new investor account would be excluded. Under the proposed rules, a firm also would be required to adopt, implement and (for broker-dealers) maintain written policies and procedures reasonably designed (for broker-dealers) to achieve compliance with and (for investment advisers) to prevent violations of the proposed rules. Firms would also be subject to certain recordkeeping and retention requirements related to the proposed rules.

Comments on the proposal are due by October 10, 2023.

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

GUIDANCE AND ALERTS

SEC Staff Issues Risk Alert Regarding Observations from Anti-Money Laundering Compliance Examinations of Broker-Dealers

On July 31, 2023, the SEC's Division of Examinations issued a risk alert presenting observations regarding deficiencies with respect to compliance with key anti-money laundering (AML) requirements observed in compliance examinations of registered broker-dealers. Registered broker-dealers are required to maintain and implement written AML programs that are approved in writing by senior management and that include certain items. In particular, the AML program must be reasonably designed to achieve compliance with the Bank Secrecy Act (BSA) and to detect and cause reporting of suspicious transactions under 31 U.S.C. § 5318(g). In the risk alert, the SEC staff encouraged broker-dealers to review and strengthen policies, procedures and internal controls of their AML programs and to monitor for amendments, pursuant to the Anti-Money Laundering Act of 2020 and the Corporate Transparency Act, to the rules implementing the BSA.

In the risk alert, the staff noted the following observations relative to AML compliance:

- The staff observed firms that failed to conduct independent testing of their AML programs in a timely manner, that could not demonstrate whether testing had occurred or that had inadequate or ineffective independent testing. Instances of inadequate testing included testing that did not cover certain aspects of the firm's business or AML program, interested personnel conducting tests, personnel conducting tests without AML expertise and testing that was conducted under requirements that do not apply to the securities industry. The staff also noted firms that did not timely address or have procedures to address matters identified through independent testing.
- The staff observed firms with outdated training materials or materials that were not tailored to the firm's particular risks, typologies, products and services or business activities. Certain firms also could not demonstrate that all appropriate personnel attended ongoing training sessions and had no process for ensuring all relevant personnel completed training.
- The staff observed firms whose Customer Identification Programs (CIPs) would not allow the firm to form a reasonable belief of the true identity of customers. These observations included, among other things, failure to apply CIP procedures to investors in a private placement "where customer relationships established with the registrant to effect securities transactions appeared to be formal relationships for purposes of the CIP Rule," failure to collect relevant customer identification data, accounts that were permitted to be opened by individuals who only provided a P.O. box address and programs that did not verify customer identities or keep correct records of whether identity verification occurred.
- The staff observed firms that had not updated their AML programs or new account forms and procedures to account for the adoption of the customer due diligence rule, adopted in 2016, which "requires a broker-dealer's AML program to contain written procedures that are reasonably designed to identify and verify the identity of beneficial owners of legal entity customers." The staff observed firms that permitted an entity to be listed as a beneficial owner without obtaining adequate information about that entity's beneficial owners, allowed the opening of new accounts without identifying a legal entity's beneficial owners, failed to document the identity of beneficial owners of legal entity customers and failed to follow internal procedures requiring the firm to obtain information about certain underlying parties acting through omnibus accounts.
- Finally, the staff observed firms that did not have the necessary resources to support AML compliance despite the current environment of new and increasing sanctions imposed by the Office of Foreign Assets Control.

The risk alert is available here.

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