Investment Services Regulatory Update

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Monthly Version

Vedder Price

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New Rules, Proposed Rules, Guidance and Alerts

NEW AND PROPOSED RULES

U.S. Department of Labor Issues Final Fiduciary Rule

On April 23, 2024, the U.S. Department of Labor (DOL) issued a final rule, amending the definition of an investment advice fiduciary for purposes of the Employee Retirement Income Security Act (ERISA) and the Internal Revenue Code, as well as related amendments to prohibited transaction exemptions (PTEs) available to fiduciaries under ERISA (collectively, the Final Regulations). The Final Regulations generally take effect on September 23, 2024, with a one-year transition period for certain conditions in the PTEs. The Final Regulations broaden who qualifies as an investment advice fiduciary and are designed to align ERISA's fiduciary protections with reasonable retirement investor expectations of trust and confidence.

The DOL previously attempted to redefine an investment advice fiduciary in a 2016 rulemaking, which was ultimately invalidated by the U.S. Court of Appeals for the Fifth Circuit in 2018 as beyond the DOL's authority, finding that it was overbroad and applied to relationships that lacked "trust and confidence." The Final Regulations are similarly not without controversy. On May 2, 2024, an insurance industry trade organization, along with five other insurance industry plaintiffs, filed suit in the U.S. District Court for the Eastern District of Texas, challenging the Final Regulations on similar grounds.

The Final Regulations amend the DOL's 1975 regulation that sets forth a five-part test for determining who is an investment advice fiduciary. Under the prior five-part test, a person is a fiduciary if they: (1) render advice as to the value of securities or other property, or make recommendations as to the advisability of investing in, purchasing, or selling securities or other property (2) on a regular basis (3) pursuant to a mutual agreement, arrangement, or understanding with the plan or a plan fiduciary that (4) the advice will serve as a primary basis for investment decisions with respect to plan assets, and that (5) the advice will be individualized based on the particular needs of the plan. Citing changes in the retirement plan landscape since 1975, notably the shift from defined benefit plans to participant-directed defined contribution/individual account plans, the DOL adopted a revised definition of fiduciary that focuses more broadly on recommendations made by a person who "makes professional investment recommendations to investors on a regular basis as part of their business" under circumstances in which a reasonable retirement investor would believe that the person occupies a position of trust and confidence. The Final Regulations generally provide that a financial services provider is a fiduciary if: (1) the provider makes an investment recommendation to a retirement investor; (2) the recommendation is provided for a fee or other compensation; and (3) the financial services provider holds itself out (in ways specified in the Final Regulations) as a trusted adviser.

Under the revised definition, an investment advice fiduciary is no longer limited to persons who provide advice on a regular basis pursuant to a mutual agreement that the advice will serve as the primary basis for the retirement investor's investment decision. Significantly, these changes now extend fiduciary status to "one-time" advice, including advice related to rollover transactions. Given the removal of the mutual agreement requirement, the Final Regulations clarify that fiduciary status would not apply to providers marketing their own services (so-called "hire me" communications), absent an investment recommendation. In addition, the DOL declined to include in the Final Regulations a carve-out for recommendations to certain sophisticated advice recipients, such as plan sponsors acting as plan fiduciaries or independent financial services providers who are themselves plan or individual retirement account fiduciaries.

The Final Regulations are available as follows: final rule, PTE 2020-02 amendment, PTE 84-24 amendment and additional PTE amendments. A related fact sheet is available here, and the DOL's news release is available here.

The FTC's Game-Changing Ban on Non-Competes Takes Effect September 4 Absent Court Intervention

On September 4, 2024, the Federal Trade Commission's groundbreaking Final Rule prohibiting employers from imposing or seeking to enforce non-competes goes into effect. The Final Rule bans all future non-competes and also requires employers to affirmatively notify, by September 4th, current and former workers (excluding a limited class of senior executives) that their non-competes are void as of that date.

On April 27, 2024, attorneys in Vedder Price's Labor & Employment and Litigation groups published an article discussing the FTC's Final Rule, available here.

GUIDANCE AND OTHER DEVELOPMENTS

SEC Staff's Latest Marketing Rule Risk Alert Highlights Initial Observations from Examinations

On April 17, 2024, the SEC's Division of Examinations issued its latest risk alert regarding Rule 206(4)-1 of the Investment Advisers Act of 1940, known as the Marketing Rule. Following the examinations staff's June 2023 and September 2022 risk alerts regarding areas of emphasis in examinations focused on compliance with the Marketing Rule, the latest risk alert highlighted initial observations from examinations of investment advisers' compliance with the Marketing Rule and related rules under the Advisers Act. The risk alert focused on compliance with the Marketing Rule's general prohibitions, Rule 206(4)-7 (the Compliance Rule), Rule 204-2 (the Books and Records Rule), and Form ADV disclosure requirements.

General Prohibitions. Observations related to the Marketing Rule's general prohibitions included advertisements containing untrue and unsubstantiated statements of material fact; omissions of material facts or misleading inferences; and statements about the potential benefits connected with the advisers' services or methods of operation, specific investment advice, and performance results or performance time periods that were not presented in a fair and balanced manner. Examples noted by the staff included advertisements publicizing the receipt of certain awards or accolades that were not received, advertisements recommending certain investments without disclosing the adviser's conflicts of interest, and advertisements including misleading testimonials.

Compliance Rule. The examinations staff observed instances where advisers' policies and procedures were not reasonably designed or implemented to address compliance with the Marketing Rule, in violation of the Compliance Rule. Examples noted by the staff included policies and procedures that were informal, rather than in writing; consisted only of general descriptions and expectations related to the Marketing Rule; were incomplete, not updated, or only partially updated for certain applicable marketing topics; and were not tailored to address advisers' specific advertisements.

Books and Records Rule. The examinations staff observed instances where advisers were deficient with respect to Marketing Rule-related books and records maintenance and preservation requirements. Examples noted by the staff included advisers not maintaining copies of information posted to social media and not maintaining documentation to support performance claims included in advertisements.

Form ADV. The examinations staff observed Marketing Rule-related deficiencies on advisers' Form ADV, such as inaccurately reporting on Form ADV, Part 1A, that their advertisements did not include third-party ratings, performance results, or hypothetical performance when such information was in fact included in the advisers' advertisements.

In sharing its observations, the SEC staff encouraged investment advisers "to reflect upon their own practices, policies, and procedures and to implement any appropriate modifications to their training, supervisory, oversight, and compliance programs."

The risk alert is available here.

Litigation and Enforcement Matters

ENFORCEMENT DEVELOPMENTS

SEC Settles Enforcement Proceedings Against Five Advisers for Alleged Marketing Rule Violations

On April 12, 2024, the SEC announced the settlement of administrative proceedings brought against five registered investment advisers for alleged violations of Rule 206(4)-1 under the Investment Advisers Act of 1940, known as the Marketing Rule. Among other things, the Marketing Rule prohibits advisers from using hypothetical performance information in advertising material unless they have adopted and implemented policies and procedures to ensure that the information is relevant to the likely financial situation and investment objectives of the advertisement's intended audience. Hypothetical performance information includes the performance of model portfolios and backtested performance returns derived from applying a strategy to historical data from periods when the strategy was not actually employed.

The SEC alleged that all five advisers advertised hypothetical performance information on their public websites without adopting and implementing policies and procedures required by the Marketing Rule. In addition, the SEC alleged that one of the advisers violated other provisions of the Marketing Rule, including by making false and misleading statements in advertisements, advertising misleading model performance, being unable to substantiate performance shown in its advertisements, and failing to enter into written agreements with people it compensated for endorsements, and that the adviser also violated recordkeeping and compliance rules. The SEC also alleged that this same adviser made misleading statements about its performance to a registered investment company client, which were then incorporated into the client's prospectus filed with the SEC.

The SEC found that the five advisers willfully violated Section 206(4) of the Advisers Act, which makes it unlawful for any adviser to engage in fraudulent, deceptive or manipulative business practices, as well as the Marketing Rule. In addition, the SEC found that one adviser violated Section 206(2) of the Advisers Act, which makes it unlawful for an adviser to engage in fraud or deceit upon any client or prospective client, Section 204 of the Advisers Act and rules thereunder, which set forth advisers' recordkeeping requirements, and Section 34(b) of the Investment Company Act of 1940, which makes it unlawful for any person to make any untrue statement of a material fact, or omit to state any fact necessary in order to prevent the statements made in the light of the circumstances under which they were made from being materially misleading, in any registration statement or other document filed or transmitted pursuant to the Investment Company Act.

Without admitting or denying the allegations, the advisers agreed to cease and desist from future violations, to be censured, to comply with certain undertakings and to pay civil monetary penalties ranging from $20,000 to $30,000, except that the adviser alleged to have violated additional provisions of the Marketing Rule, the Advisers Act and also the Investment Company Act agreed to pay a civil monetary penalty of $100,000.

These settlements represent the second set of enforcement actions settled by the SEC stemming from the SEC's ongoing targeted sweep examinations concerning Marketing Rule violations. In September 2023, the SEC settled enforcement actions against nine registered investment advisers involving alleged violations of the Marketing Rule. In announcing the five most recent settlements, Corey Schuster, Co-Chief of the SEC Enforcement Division's Asset Management Unit, stated that, "[t]oday's actions show that we will continue to employ targeted initiatives to ensure that investment advisers fully comply with their obligations under the [Marketing Rule]. They also serve as a reminder of the benefits to firms that take corrective steps before being contacted by Commission staff."

The SEC's press release announcing the settlements can be found here.

SEC Settles Enforcement Proceedings Against Adviser for Improperly Splitting Legal Fees with Mutual Fund Client

On April 29, 2024, the SEC announced the settlement of administrative proceedings brought against a registered investment adviser for alleged violations of Section 17(d) of the Investment Company Act of 1940, Rule 17d-1 thereunder, and Section 206(2) of the Investment Advisers Act of 1940 related to an impermissible joint legal fee arrangement with its mutual fund client.

According to the order, the adviser and the fund began receiving inquiries from the SEC and another regulator beginning in February 2017 related to the fund's recent significant losses, and this was followed by two private lawsuits filed in April 2017 and August 2017. The SEC alleged that the adviser and the fund retained the same legal counsel because the regulators' inquiries and the private lawsuits involved overlapping facts and legal issues. The SEC further alleged that the adviser did not have an insurance policy to cover its legal costs from the inquiries and lawsuits, while the fund did have an insurance policy that would cover its legal costs from these matters. According to the order, the adviser initially arranged for the fund to pay all legal fees and costs related to the regulatory inquiries and private lawsuits, including for the adviser's legal representation, without the approval or knowledge of the fund's independent trustees, and that between May 2017 and March 2020 the fund paid approximately $2.5 million in legal fees and costs associated with counsel's representations of both entities. The adviser subsequently reimbursed the fund for a portion of the legal expenses. The SEC alleged that the adviser benefitted from the impermissible joint arrangement by, among other things, deferring payment of its legal bills for multiple years.

The SEC found that the adviser willfully violated Section 17(d) of the Investment Company Act and Rule 17d-1 thereunder, which generally prohibit any affiliated person of a registered investment company, acting as principal, from participating in or effecting any transaction in any joint enterprise with the registered investment company, and Section 206(2) of the Advisers Act, which makes it unlawful for an adviser to engage in fraud or deceit upon any client or prospective client. Without admitting or denying the allegations, the adviser agreed to cease and desist from future violations, to be censured, and to pay disgorgement and interest totaling approximately $310,000 (offset by a prior payment to the fund) and a civil monetary penalty of $200,000.

The SEC's order is available here, and a related press release is available here.

SEC Settles Enforcement Proceedings Against Adviser Regarding Alleged "Pay-to-Play" Political Contribution

On April 15, 2024, the SEC announced the settlement of administrative proceedings brought against a registered investment adviser for alleged violations of Section 206(4) of the Investment Advisers Act of 1940 and Rule 206(4)-5 thereunder, known as the "pay-to-play" rule, concerning a political campaign contribution. The "pay-to-play" rule prohibits registered investment advisers from providing investment advisory services for compensation to a government entity within two years after the adviser or its covered associate makes a contribution to an official of the government entity, including a candidate for office.

According to the order, a covered associate of the adviser made a campaign contribution to a candidate for elected office, which office had influence over selecting investment advisers for a state investment board. The state investment board had previously invested in private equity funds advised by the adviser and, during the two years after the contribution, the adviser continued to provide advisory services for compensation to these funds, in which the state investment board remained invested.

The SEC found that the adviser willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-5 thereunder. Without admitting or denying the allegations, the adviser agreed to cease and desist from future violations, to be censured and to pay a civil monetary penalty of $60,000.

Commissioner Hester Peirce issued a statement of dissent regarding the settlement in which she criticized the rule's role in inhibiting legitimate political participation by employees of investment advisers, including by discouraging them from making campaign contributions or by preventing them from soliciting donations in the investment advisory industry should they choose to run for office. While acknowledging that the concerns about public corruption underlying the rule are important, Commissioner Peirce noted her view that there are better ways of addressing such concerns without penalizing advisers and their employees for merely expressing their political preferences.

The SEC's order is available here. Commissioner Peirce's statement of dissent is available here.

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