FINTECH Law™

MONTHLY NEWSLETTER

AUGUST 2022

FinTech Law is an innovative, technology-driven law firm that provides legal and consulting services to startups, crypto-related and other technology companies, investment advisers, broker-dealers, private funds, registered funds, and other financial services companies.

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Highlights

In July's newsletter, we mentioned that the SEC (Securities and Exchange Commission) continues to focus on crypto-assets, as noted in its 2022 examination priorities, and has almost doubled the size of its crypto enforcement unit. The increase in the Division of Enforcement's Crypto Assets and Cyber Unit was announced on May 3, 2022. While crypto news was top-of-mind at the beginning of the month, traditional rule proposals dominated the remainder of the month.

Less than a month after proposing new rules for private fund advisers and making the private fund a top examination priority, the SEC quickly switched its focus to registered funds, including mutual funds and ETFs (exchange traded funds). On May 23, 2022, the SEC announced charges against BNY Mellon for misstatements related to registered ESG funds (read below for more details). Environmental, social, and governance (ESG) funds have been a hot commodity for active managers trying to justify their higher-than-index fund fees. But a lack of clear industry standards around such products has caused some to raise allegations that ESG is just a wolf in sheep's clothing (i.e., a marketing ploy to herd investors into traditional equity grazing grounds). The SEC seems to agree and used the BNY Mellon case to get the industry's attention.

Although the BNY Mellon fine ($1.5 million) was small, the SEC used it as a bully pulpit to announce that the SEC "will hold investment advisers accountable when they do not accurately describe their incorporation of ESG factors into their investment selection process," as noted by Adam S. Aderton in the press release for the matter. Mr. Aderton is the co-chief of the SEC Enforcement Division's Asset Management Unit and a member of the division's Climate and ESG Task Force.

One of the most common critiques of the SEC by industry is that the commission tends to regulate by enforcement. To avoid this decades-old argument, the SEC followed up the BNY Mellon matter with two rule proposals: Rule Changes to Prevent Misleading and Deceptive Fund Names ("Names Rule Amendments") and Enhanced Disclosures by Certain Investment Advisers and Investment Companies About ESG Investment Practices ("ESG Disclosure Rule"). While the Names Rule Amendments are broader than ESG and include funds that use "growth" and "value" in their names, ESG was clearly a major focus of the rule (read more below). The ESG Disclosure Rule, discussed below, would impact investment disclosure in registration statements, shareholder reports, Form ADV, and other filings. And don't forget that the new Derivatives Rule (18f-4) takes effect on August 18, 2022, and the new Valuation Rule (2a-5) takes effect on September 8, 2022.

All these rule releases and effective dates come at a time of economic uncertainty and rising costs, putting further pressure on asset managers, and registered and unregistered funds. Inflation is near 12 percent, layoffs are increasing, the Russian invasion of Ukraine continues to disrupt energy supplies and is now disrupting food sources and other products, and here in the United States (and around the world) we expect to keep seeing high summer temperatures that will further stress the economy (along with everyone's tempers). At times, it seems like shocking news is boiling over.

Nevertheless, we should remember that markets have been through an incredible bull run that survived a global pandemic. We should remember that we're coming off record highs for market valuations, record rounds of venture capital funding, and a hot labor market. Like my German Shepherd who uses our pool to stay cool in the summer, sometimes markets just need to cool off.

SEC

Regulatory Activity

SEC Updated Requirements for Valuation Procedures with Rule 2a-5

The SEC has provided new requirements to determine fair value of fund investments in good faith. With this, a fund's board may designate a "Valuation Designee" to oversee some or all of the fund's investments, so long as that Valuation Designee is subject to the board's oversight. The Valuation Designee would need to periodically assess and manage valuation risks; test, establish, and apply appropriate fair value methodologies and periodically review the methodologies; and establish a process for evaluating and monitoring any pricing services utilized.

Proposed Changes to ESG Disclosures

In late May, the SEC proposed amendments to rules and reporting forms to establish disclosure requirements with regards to a fund's and advisers' incorporation of environmental, social, and governance (ESG) factors. If adopted, the amendments would create categories for certain types of ESG strategies and require funds and advisers to disclose new information in prospectuses, annual reports, and adviser brochures regarding the ESG strategies they are pursuing and the environmental considerations they advertise.

Proposed Changes to Names Rule Enhance Requirements

A proposed rule to modernize the SEC's Names Rule would require more funds to adopt an 80 percent investment policy. Current requirements for investment companies whose names suggest a focus in a certain area of investment must invest at least 80 percent of the value of their assets in that area. If adopted, the changes to the Names Rule would extend these requirements to more funds, in particular to funds whose names suggest characteristics other than investment areas.

SEC Exam Priorities for 2022

The SEC's Division of Examinations publishes its examination priorities annually to provide insight into its risk-based approach, particularly its examination into areas it believes present potential risks to investors and the integrity of the U.S. capital markets. On March 30, 2022, the Division announced that its 2022 examination priorities will focus on private funds, ESG investing, retail investors and working families, information security and Operational Resiliency, and emerging technologies and crypto-assets. We highlight a few of these areas of focus below.

1. Private Funds. The SEC will focus on areas such as risk assessments, compliance programs, fees and expenses, custody, fund audits, valuation, conflicts of interest, disclosures, and controls around material non-public information.

2. ESG. Areas of focus include accuracy of disclosures in investment policies, compliance programs, whether proxy voting aligns with the product's investment strategy, and whether ESG factors considered during the investment process are accurately disclosed and effectively implemented.

3. Emerging Technologies and Crypto-Assets. The SEC will examine the use of emerging fintech by broker-dealers and investment advisers, including how such systems can impact the registrant's compliance program. For example, the SEC will examine whether algorithms are behaving in a way that complies with a product's disclosures and an investor's investment strategy. For crypto-assets, the SEC will focus on custody arrangements and selling practices.

The staff's report also included data on fiscal year 2021 examinations. During that period, the staff conducted 3,040 exams, a 3 percent increase from fiscal year 2020. From those exams, the staff issued 2,100 deficiency letters, about 69 percent of all exams. The most common deficiencies included ineffective or missing policies and procedures and inaccurate disclosures to investors. As a result of these exams, more than $45 million was returned to investors and the Division of Examinations referred 190 matters to the Division of Enforcement.

The Investment Adviser/Investment Company (IA/IC) Examination Program continues to be the Division's largest program, accounting for 2,200 of the exams, or 72 percent. In fairness, FINRA conducts most of the broker-dealer and exchange exams, freeing up the SEC's resources to focus on other areas. Statistically, the SEC examines 15 percent of all investment advisers per year, which means most advisers will be examined only once every 6.7 years. But the Commission notes that the growth in advisory firms is outpacing the growth in the Commission's budget and internal resources. "[O]ver the past 5 years, the number of RIAs has increased 20%, from [about] 12,250 to over 14,800." Most of this growth has been in larger advisers ($10B+), which have increased by 30 percent.

SEC Proposes Short Sale Disclosure Rule, Order Marking Requirement, and CAT Amendments

A new rule and form proposed by the SEC would require certain institutional managers to report information related to short sales to the SEC monthly. Should the new rule be adopted as proposed, the SEC would publish aggregate information pertaining to short positions regarding individual equity securities and net activity during the month, with the goal that the information will supplement short sale transaction information provided by U.S. stock exchanges and FINRA.

SEC Proposes Rule Change to Reduce Risks in Clearance and Settlement for Broker-Dealers

The SEC proposed a change to rules regarding the standard settlement cycle for broker-dealer transactions, shortening the cycle from two business days to one business day, as well as shortening the process of confirming and affirming trade information needed to prepare a transaction for settlement. Proposed rules will also now require central matching service providers to facilitate the achievement of "straight-through processing," automating the entire trade process. Additionally, the SEC proposed changes regarding paths to achieving a same-day settlement cycle.

SEC Proposes Major Rule Changes for Private Fund Advisers

The SEC proposed new rules under the Investment Advisers Act of 1940 which, if adopted, would require advisers to distribute quarterly statements to private fund advisers disclosing detailed information regarding fees, expenses, and performance so that investors could track the full cost of investing in private funds. The new rule would also require the private funds to undergo annual financial statement audits and obtain a fairness opinion regarding adviser-led secondary transactions. Additionally, private funds would need to disclose any preferential treatment to certain investors (i.e., disclose the preferential terms in side letters to all investors). Finally, the new rule would require registered advisers to document annual compliance reviews in writing.

New Cybersecurity Rules for Investment Advisers and Investment Companies

The SEC proposed new rules under the Investment Advisers and the Investment Company Acts of 1940, which, if accepted, would require investment advisers and registered investment companies 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 others.

Proposed Rules regarding Security-Based Swaps Transactions and Undue Influence over CCOs

In December 2021, the SEC voted to propose new rules it says will prevent fraud, manipulation, and deception regarding security-based swaps and require persons or groups who own a significant security-based swap position to file a statement with the SEC containing certain information, which will be made publicly available.

Money Market Reform Rule Proposals

The SEC proposed significant money market reforms, which were approved on December 15, 2021. The reforms amend Rule 2a-7 under the Investment Company Act of 1940, increasing daily and weekly liquid asset requirements for all money market funds (MMFs); modifying stress testing requirements; requiring MMFs to calculate their “dollar-weighted average portfolio maturity” (WAM) and “dollar-weighted average life maturity” (WAL) using the market values of their portfolio securities; removing liquidity fee and redemption gate provisions; and imposing a new swing pricing regime for non-government institutional MMFs.

Transparency in Material Terms Reporting

The SEC proposed a new rule under the Securities Exchange Act of 1934, which would require lenders of securities to report the material terms of their securities lending transactions to a registered national securities association (RNSA), such as FINRA, “which would in turn make public certain information about each securities lending transaction as well as aggregated information about securities on loan and available for loan.”

SEC

Enforcement Actions

Four Whistleblowers Receive Monetary Award

A $3.5 million award was given to four whistleblowers whose reports and insights led to the opening of an investigation, leading to a single, successful enforcement action. Ever since issuing its first award in 2012, the SEC has awarded roughly $1.3 billion to 281 individuals. Payments are made out of an investor protection fund established by Congress, which is financed through sanctions paid to the SEC by securities law violators.

Massive Valuation Fraud by Mutual Fund Manager

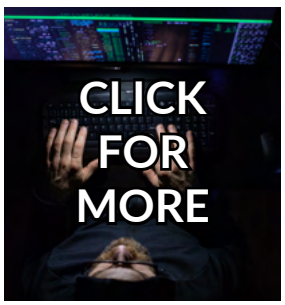
The SEC filed a complaint in District Court for the Southern District of New York, alleging that the former CIO and founder of Infinity Q Capital Management engaged in fraud to overvalue assets held by a mutual fund and a private fund the adviser managed between 2017 through February 2021, in order to inflate the advisory fees paid by the funds.

Form CRS Actions

The SEC announced settlements with 12 firms relating to the alleged failure to file and deliver Form CRS relationship summaries to their retail clients by the required deadlines, and failure to include all necessary information to satisfy Form CRS requirements.

Independence Standards Breached by Failure to Disclose

The SEC settled an administrative proceeding brought against Leaf Group Ltd. in January 2022. The SEC alleged that the company violated provisions and rules under the Securities Exchange Act of 1934 by failing to evaluate and disclose business relationships, resulting in a purportedly independent director to breach applicable independence standards.



SEC

Other Activities

SEC Adopts Rules Requiring Electronic Filings for Investment Advisers and Institutional Investment Managers

The SEC amended Form 13F to require certain documents filed by investment advisers, institutional investment managers, and other entities to be filed or submitted electronically. These amendments, as stated by the SEC, are intended to modernize the manner in which information is submitted to the SEC and disclosed to the public, thereby promoting efficiency. Specifically, electronic filings are now easier to access and search, solving a problem related to the operational issues that arose from the spread of COVID-19.

Enforcement Division Expands Its Crypto Assets and Cyber Unit

The SEC added 20 additional positions to the Cyber Unit, which has also been renamed the Crypto Assets and Cyber Unit, in the Division of Enforcement. The unit was created in 2017, and is charged with enforcement actions related to fraudulent and unregistered crypto-assets. The goal of increasing the size of this unit is to better monitor crypto markets while continuing to "identify disclosure and controls issues with respect to cybersecurity."

Problematic Form CRS Filings

The SEC's Standards of Conduct Implementation Committee issued a statement outlining its observations after its review of Form CRS relationship summaries filed with the SEC. The Committee noted various problematic disclosures and disclosure practices, including the use of highly technical jargon without providing clear explanations, omitting or modifying required disclosures, failing to describe substantive topics the form required firms to address, a lack of clarity regarding disciplinary history disclosures and relationship summaries, and the use of marketing language and superlatives in some relationship summaries.

2021 Record Year for Whistleblower Awards

The SEC announced its enforcement results stemming from the 2021 fiscal year. It reported that 434 new enforcement actions were filed in 2021, a 7 percent increase over the 2020 fiscal year. The filings involved new or developing areas of securities, including crypto, SPACs, and Form CRS compliance. The SEC cited its whistleblower program as critical to its enforcement efforts, and noted that fiscal year 2021 was a record year for whistleblower awards.

Reminders for Obligations Related to LIBOR Transition

The SEC staff issued a statement to remind market participants of their obligations related to the LIBOR transition. The staff stated that the transition away from LIBOR as a reference rate for different types of investments meant that investment professionals must be mindful of their obligation to consider the best interest standard under Regulation Best Interest and their fiduciary obligations when recommending LIBOR-related securities and investment strategies involving LIBOR investments.

SEC Chair States Objectives for Private Funds Oversight

SEC Chair Gary Gensler delivered remarks at the Institutional Limited Partners Association (ILPA) Summit, stating his objectives for the SEC's oversight of private funds and highlighting potential areas of increased regulatory scrutiny, particularly regarding transparency around fees and expenses to fund investors, whether side letter provisions should be permitted, increasing transparency regarding performance metrics, mitigating the effects of conflicts of interest, and reporting and disclosure through Form PF.

FINRA

Enforcement Actions

AML Compliance Officer Settles for Oversight Failure

A former anti-money laundering (AML) compliance officer for a large broker-dealer firm—which agreed to pay a $38 million fine regarding its AML program in 2020—recently settled a FINRA enforcement matter. The former compliance officer paid a $25,000 fine for failing to oversee the broker-dealer firm's AML program. The individual was also prohibited from associating with any FINRA member for two months from the settlement date, and agreed to complete 10 hours of AML education.

IRS

The IRS issued Revenue Procedure 2021-53 in December, which modified Revenue Procedure 2017-45 by providing guidance regarding the treatment of certain stock distributions by publicly offered regulated investment companies (RICs) and real estate investment trusts (REITs). Revenue Procedure 2017-45 provides a safe harbor under which publicly offered RICs and REITs may permit shareholders to elect to receive a distribution in stock in lieu of cash, with certain provisions.

Private Actions

SABA Capital CEF Opportunities 1 et al. vs. Nuveen Floating Rate Income Fund et al.

Institutional investors brought an action against several closed-end funds organized as Massachusetts business trusts and their trustees. The action sought rescission of a control share bylaw provision and declaratory judgment to the effect that the control share bylaw is illegal.