MONTHLY NEWSLETTER

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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

The past few months have been dominated by market volatility, the implementation of new SEC rules, and uncertainty around the regulation of digital assets. On **August 18, 2022,** Rule 18f-4 (Derivatives Rule) under the Investment Company Act took effect. Smaller fund managers were scrambling to deal with a rule that added substantial cost to the management of registered investment companies. Further, many small and mid-sized investment advisers do not have professional risk managers on staff, making compliance even more difficult (or ineffective).

A few weeks later, fund managers had to address the compliance date for Rule 2a-5 (Valuation Rule). While this rule was easier to implement, since it basically codified existing guidance, it had a huge impact on Rule 17a-7 cross-trade transactions. Under the SEC's new definition of "readily available market price" fixed-income securities, including municipal securities, are essentially prohibited from such affiliated transactions. In response, many fund managers have updated their Rule 17a-7 policies and procedures to prohibit cross-trades of such securities.

Now, all investment advisers are turning to the new Rule 206(4)-1 (Advertising Rule), which allows them to use technology, testimonials, and endorsements in new ways, as noted in Joot's blog posts Getting Ready for the New SEC Marketing Rule: Insights from the Field. To comply with the new rule, advisers need to evaluate how their present performance, including hypothetical or back-tested performance, in their fact sheets, on their websites, and elsewhere. The new rule also impacts how advisers can use social media and new requirements for solicitation agreements. The compliance date for the new rule is **November 4, 2022.**

SEC

Regulatory Activity

SEC Staff release Expectations Regarding Conflicts of Interest

The SEC released an FAQs bulletin regarding standards of conduct for broker-dealers under Regulation Best Interest, as well as standards of conduct for investment advisers under the Adviser's Act. The SEC stated that the bulletin is meant to emphasize that addressing conflicts should entail a "robust, ongoing process that is tailored to each conflict." The bulletin acknowledges that all firms and financial professionals have some conflicts of interest with their retail investors

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 Issues Risk Alert on Recent Observations from Municipal Advisor Examinations

The SEC recently issues this risk alert to raise awareness of the most cited deficiencies and weaknesses observed in recent municipal advisor examinations. The Staff observations included deficiencies in the following areas:

- **Registration and Filings:** Filings were inaccurate, incomplete or contained inconsistent information, amendments and MSRB fees were not paid.
- **Recordkeeping:** Municipal advisors did not maintain true, accurate and current books and records for written communications, financial records, compliance documentation, written consents, copies of recommendations made to a municipal entity or obligated person and written agreements entered into with municipal entities.
- **Supervision:** Observed deficiencies included failure to establish, amend or design Written Supervisory Procedures and failure to conduct annual reviews.
- **Disclosure to Clients (MSRB Rule G-42):** Observed deficiencies under MSRB Rule G-42 included failure to document and disclose material conflicts of interest. The SEC also noted that Municipal Advisor did not provide clients with written statements that there were no identified material conflicts of interest.

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 Issues Risk Alert on the New Investment Adviser Marketing Rule

The SEC recently issued this risk alert to announce they will be conducting examinations that focus on key components of the new Marketing Rule. The exams will focus on the following areas:

- **Marketing Rule Policies and Procedures:** Staff will review the implementation of written policies and procedures to ensure they are reasonably designed and effective. The staff specifically states the procedures should be objective and testable.
- **Substantiation Requirement:** Staff will review whether investment advisers have a reasonable basis for believing they will be able to substantiate material statements of fact in advertisements.
- **Performance Advertising Requirements:** Staff will review the compliance requirements with performance advertising, including the following:
    - Gross performance, and net performance is presented equally;
    - Specific time periods are used when displaying any performance results, private funds are excluded from this requirement:
    - Any statement that the Commission has approved or reviewed any calculation or presentation, is strictly prohibited;
    - Extent an advertisement includes the performance of portfolios other than the portfolio being advertised, performance results from fewer than all portfolios with similar investment policies, objectives and strategies as the portfolio being offered in the advertisement;
    - If extracted performance results from a subset of investments from a portfolio, are advertised, the Adviser must disclose that the Adviser will provide or offer to provide promptly, the performance results of the total portfolio;
    - If the Adviser advertises hypothetical performance, the adviser must adopt and implement policies and procedures; and
    - If predecessor performance is advertised the personnel primarily responsible for achieving the prior performance is managing accounts at the advertising adviser and the accounts that were managed by those personnel are sufficiently similar to the accounts, they manage at the advertising adviser.
- **Books and Records:** The Staff will review the investments adviser's compliance with the amended Books and Records Rule, along with the proper updates to the ADV in the next annual Form ADV amendment.

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.

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.

SEC Adopts Amendments to Proxy Rules Governing Proxy Voting Advice

The SEC adopted amendments to rules governing proxy voting advice. The final amendments rescind two rules applicable to proxy voting advice businesses, regarding the availability of two exemptions from the proxy rule’s information and filing requirements that proxy voting advice businesses rely on. The amendments also delete the 2020 changes made to the proxy rules’ liability provisions and affirm that proxy voting advice generally is subject to liability under the proxy rules.

SEC Adopts Pay versus Performance Disclosure Rules

The SEC adopted amendments to rules that require registrants to disclose information reflecting the relationship between executive compensation actually paid and the registrant's financial performance. The registrant will be required to disclose specified executive compensation alongside measures of performance which include, total shareholder return ("TSR"), the TSR of the registrant's peer group, net income and a financial performance measure chosen by the registrant for the last five fiscal years.

SEC Adopts Amendments to the Whistleblower Rules

The SEC adopted two amendments to the whistleblower rule. Rule 21F-3 was amended to allow the Commission to pay whistleblower awards for certain actions brought by other entities, including certain federal agencies, where the award might have been paid under the other entity's whistleblower program. The second amendment affirms the Commission's authority to consider the dollar amount of the potential award for increasing the amount and eliminates the Commission's authority to decrease the amount of the potential award.

SEC Proposes Enhanced Disclosures on Environmental, Social and Governance ("ESG") Investment Practices

The SEC proposed amendments to rules and reporting requirements for investment advisers and investment companies' incorporation of ESG factors. The amendments would require more specific disclosures in fund prospectuses, annual reports and adviser brochures on the ESG strategies they pursue. For example, if a Funds' focus is environmental factors, they would be required to disclose the greenhouse gas emissions associated with their portfolio investments. Also, Forms N-CEN and ADV Part 1A would be updated to require ESG reporting.

SEC Proposes Enhancements to Private Fund Reporting

The SEC proposed amendments to Form PF to enhance the SEC's oversight of private fund advisers. The proposed enhancements include:

- **Enhance Reporting by Large Hedge Fund Advisers on Qualifying Hedge Funds:** Large hedge advisers would be required to report investment exposures, borrowing and counterparty exposures, 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.
- **Enhance Reporting on Basic Information about Advisers and the Private Funds they Advise:** The Adviser would report additional identifying information, assets under management, withdrawal and redemption rights, gross and net asset values, inflows and outflows, base currency, borrowings and types of creditors, fair value hierarchy, beneficial ownership and fund performance.
- **Enhance Reporting for Hedge Funds:** Hedge funds would be required to provide more detailed information about investment strategies, counterparty exposures and trading and clearing mechanisms.

SEC Proposed Amendments to Shareholder Proposal Rule

The SEC proposed amendments to Rule 14a-8 regarding the process to include shareholder proposals in a company's proxy statement. The proposal revises the following three bases for excluding a proposal:

1. Substantial Implementation: A proposal may be excluded if the company has already implemented the 'essential elements' of the shareholder proposal.
2. Duplication: If a proposal 'substantially duplicates' a previously submitted proposal for the same shareholder meeting and addresses the same matter and objective, it may be excluded.
3. Resubmission: If a proposal substantially duplicates another proposal that was previously submitted for the same company's prior shareholder meeting it would constitute a resubmission.

SEC

Enforcement Actions

Unregistered Crypto Asset Offerings Result in Suits Filed by the SEC

Three entities, each with shared control by a common owner, were charged for their roles in raising $16.5 million in unregistered crypto asset securities offerings in violation of the Securities Act of 1933. The SEC alleges that each entity conducted an unregistered offering of Dragon tokens in both a discounted "presale" to members of an investment club as well as an initial offering, both in 2017. The defendants marketed the offering to crypto investors and publicly discussed the token's investment value, pricing, and "listing" on trading platforms before offering and selling approximately $2.5 million worth of tokens to cover business expenditures between 2019-2022. The SEC filed its complaint in the U.S. District Court for the Western District of Washington, and seeks permanent injunctions, disgorgement with prejudgment interest, civil penalties, and conduct-based injunctions against each defendant.

Investment Advisers Charged by the SEC for Violating the Custory Rule and ADV Violations

The SEC charged several investment advisers who failed to comply with requirements regarding safekeeping client assets or updating disclosures to reflect the status of audits or financial statements for the private funds they advised. All of the advisers settled and paid a combined penalty fee of over $1 million. The SEC argued that these advisers either failed to have audits performed or to deliver audited financials to investors in certain private funds in a timely manner, while other advisers failed to promptly file amended Form ADV to reflect that they had received audited financial statements.

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.

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 Charges Hydrogen Technology Corp. & Former CEO for Market Manipulation

The SEC announced charges against The Hydrogen Technology Corporation, as well as its CEO and the CEO of Moonwalkers Trading Limited, for their roles in the offer and sales of crypto asset securities and manipulating the trading volume and price of the crypto asset securities. The SEC alleges that Hydrogen and Moonwalkers structured the unregistered offering and sale of the securities as bounties and employee compensation, as well as created a misleading image regarding the cryptocurrency's market activity.

SEC

Other Activities

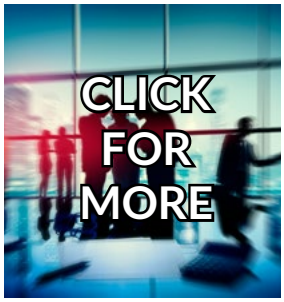
Enforcement Division Expands Its Crypto Assets and Cyber Unit

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."

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

District Court Issues Judgment in Favor of Great-West's Motion for Sanctions Against Law Firm

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. In its excessive fee case. Both Great-West and its former attorneys sought sanctions against the other, and while the court ruled in Great-West's favor, it has not issued a final award.

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.

Fund Managers, Regulators Wrestle Over Plans to Tighten ESG Rules

Both American and European regulators are working to tighten rules regarding environmental, social, and governance ("ESG") investment products. The SEC has proposed a benchmark for how investment products advertised as "sustainable" are labeled, marketed and reported. The proposals have led to criticism from investors and businesses, as it could result in investors pulling cash from funds that do not appear to adhere to the standards.