

Investment Management Legal and Regulatory Update

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LATEST DEVELOPMENTS

SEC Announces 2024 Examination Priorities

The SEC's Division of Examinations (Division) announced its 2024 examination priorities in October 2023. The report reflects the Division's experience engaging with registrants and investors through its over 1,100 staff members in 11 regional offices and in Washington, D.C.

The 2024 report was published to align with the start of the SEC's fiscal year. The Division hopes that early publication will better inform advisers, funds and broker-dealers of the key risks, trends and topics to be the focus in the upcoming year's examinations. The early release means that only eight months have passed since the publication of the 2023 examination priorities and, as a result, several focus areas from last year are included as 2024 priorities. Although the 2024 list is silent on environmental, social and governance (ESG) investing, the SEC remains active in this area and a proposed rule regarding enhanced ESG disclosures by advisers and funds is expected to be finalized in 2024.

Advisers

Fiduciary Duty of Advisers. The Division will continue to focus on:

- *Investment advice* to certain types of clients, such as older investors, and regarding complex, high cost or illiquid products and unconventional strategies.
- *Processes* for determining that investment advice is in clients' best interest, such as suitability, best execution and identifying and addressing conflicts of interest.
- *Economic incentives* for an adviser to recommend products, services or account types, such as revenue sharing, affiliated service providers and proprietary products.
- *Disclosures* to investors and whether they include all material facts relating to conflicts of interest.

Compliance Programs. The Division remains focused on compliance programs and can be expected to carefully review advisers' annual written reviews of the effectiveness of their compliance programs. Particular attention will be paid to:

- *Marketing practices*, including whether advisers adopted and implemented policies and procedures to comply with the Marketing Rule (Rule 206(4)-1 under the Advisers Act), answered the marketing-related questions accurately in Part 1 of Form ADV, and maintained supporting documentation. Marketing practice reviews will assess whether advertisements comply with the requirements for performance (including hypothetical and predecessor performance), third-party ratings, and testimonials and endorsements.

- *Compensation arrangements*, including advisers' receipt of compensation for services to clients, including registered investment companies, and fee breakpoint calculation processes.
- *Valuation assessments* regarding recommendations for clients to invest in illiquid or difficult to value assets, such as private placements.
- *Safeguarding assessments* of controls to protect clients' material non-public information, including through the use of expert networks.
- *Disclosure assessments* regarding the accuracy and completeness of regulatory filings, including Form CRS.
- *Policies and procedures for:*
 - Selecting and using third-party and affiliated service providers;
 - Overseeing branch offices; and
 - Obtaining informed consent from clients when advisers make material changes to their advisory agreements.

Advisers to Private Funds

The Division will continue to prioritize topics relevant to private funds, including:

- Portfolio management risks related to market volatility and higher interest rates, including funds that experience poor performance, significant withdrawals, increased leverage or valuation issues;
- The accurate calculation and allocation of private fund fees and expenses;
- Conflicts, controls and disclosures regarding private funds managed side-by-side with registered investment companies;
- Compliance with the custody rule under the Advisers Act, including accurate Form ADV reporting and timely completion of audits and distribution of financial statements; and
- Procedures for Form PF reporting.

Registered Investment Companies

The Division continues to prioritize examinations of mutual funds and ETFs due to their importance to retail investors, particularly those saving for retirement. The Division will prioritize examination of funds that have never been examined and those that have not been examined in recent years. Examinations may focus on:

- *Board processes* for assessing and approving advisory contracts, advisory fees and other fund fees and expenses.
- *Fee and expense procedures*, including:
 - Oversight of fee waivers and reimbursements;
 - Whether different advisory fees are charged to different share classes of the same fund;
 - Identical strategies that charge different fee structures depending on their distribution channel; and
 - High advisory fees and expenses, particularly for funds with weaker performance than peers.
- *Fair valuation practices*, including board oversight of valuation designees.
- *Derivatives risk management and liquidity risk management programs*, including board oversight.

Broker-Dealers

The Division will examine broker-dealers' compliance with Regulation Best Interest, conflicts of interest for dual registrants, the content of Form CRS, compliance with the net capital rule and other financial responsibility rules, and trading practices.

Information Security and Operational Resiliency

The Division notes that operational disruption risks remain elevated due to the "proliferation of cybersecurity attacks, firms' dispersed operations, intense weather-related events, and geopolitical concerns" and that "cybersecurity remains a perennial focus area for all registrants." The Division will focus on firms' policies and procedures, oversight of third-party vendors and responses to ransomware attacks and other cyber events. The Division will also assess employee training regarding identity theft prevention programs and firms' policies and procedures to safeguard client information.

Crypto Assets and Emerging Financial Technology

The Division continues to monitor the crypto asset markets and will examine advisers and broker-dealers to determine whether they meet the appropriate standard of conduct when advising clients, trading or recommending crypto assets. The Division will also assess whether advisers are complying with the custody requirements under the Advisers Act.

With respect to emerging technology, the Division is focused on automated investment tools, artificial intelligence and trading algorithms or platforms and the associated risks.

Anti-Money Laundering (AML)

The Division will continue to focus on AML programs to review whether funds and broker-dealers are tailoring their programs to their business model and risks, conducting independent testing, maintaining an appropriate customer identification program, and filing required Suspicious Activity Reports.

In addition, the Division will evaluate whether advisers and broker-dealers monitor and adhere to Office of Foreign Assets Control (OFAC) sanctions.

Conclusion

Advisers, funds and broker-dealers should review their compliance policies and practices to confirm they are ready for a potential SEC examination. We anticipate 2024 will remain a challenging regulatory and enforcement environment. The SEC has seven proposed rules that it intends to finalize during the second quarter of 2024.

Sources: SEC Division of Examinations Announces 2024 Priorities, SEC Press Release 2023-222 (Oct. 16, 2023), available [here](#); 2024 Examination Priorities (Oct. 16, 2023), available [here](#).

SEC Announces Enforcement Results for Fiscal Year 2023

The SEC recently announced its enforcement results for the fiscal year ended September 30, 2023, during which it recovered almost \$5 billion in civil penalties, disgorgement and prejudgment interest. The amount recovered in 2023 was the second highest amount in SEC history.

During fiscal 2023, the SEC's Division of Enforcement (Enforcement) emphasized recurring or widespread violations and the results provide insight into the SEC's priorities and enforcement trends. The SEC's press release included a summary of enforcement actions by classification, with the greatest percentage (21%) involving securities offerings, followed by investment adviser/investment company and broker-dealer actions, each at 18%. It is noteworthy that certain enforcement results cited by the SEC, such as compliance with the Marketing Rule and enforcement related to crypto assets, are included in the SEC's 2024 examination priorities, as noted above.

Enforcement Examples

The SEC cited a major settlement for over \$400 million in civil penalties regarding violations of the recordkeeping requirements of the federal securities laws by 25 advisory firms, broker-dealers and credit rating agencies. These cases involved the alleged failure to maintain electronic communications, particularly those involving off-channel messaging. In an interview with *The Wall Street Journal* related to the 2023 results, Enforcement director Gurbir Grewal stated: “. . . we’re not looking for communications about people making lunch plans or dinner plans . . . We’re looking for communications related to the business, and records that have to be kept.”

The release also noted actions against nine advisers for noncompliance with the Marketing Rule. In these cases, the SEC determined that the advisers in question had advertised hypothetical performance to mass audiences on their website without having the policies and procedures required by the Marketing Rule.

Recognizing Industry Cooperation

The release emphasized that the SEC “consistently rewarded meaningful cooperation” to promote compliance and to encourage other firms to “proactively self-police, self-report, and remediate potential securities laws violations.” Enforcement settled cases with cooperating firms in a wide range of enforcement actions, including those involving public company misstatements, recordkeeping violations and violations of whistleblower protection rules.

Whistleblower Program

The release noted that “Fiscal year 2023 was a record-breaking year for the SEC’s Whistleblower Program.” The SEC issued nearly \$600 million in whistleblower awards during the year. The SEC received a record high number of whistleblower tips (more than 18,000) in fiscal 2023, marking an approximately 50% increase over fiscal 2022. During fiscal 2023, the SEC also prioritized protecting whistleblowers’ rights by bringing enforcement actions against advisers and other firms that allegedly restricted or deterred employees from participating in whistleblower actions.

Other Enforcement Trends

Enforcement placed importance on industry trends, with a number of enforcement actions involving crypto asset securities, cybersecurity, recordkeeping and ESG. With respect to cybersecurity, the release cited two cases involving misleading disclosures about the protection of customer information and ransomware attacks, respectively.

The release also reported Enforcement’s emphasis on identifying misconduct by investment professionals and cited enforcement actions concerning conflicts of interest over the receipt of revenue sharing payments by an adviser’s affiliated custodian and an adviser charged with allegedly providing misleading information to the board members of a fund.

Source: SEC Announces Enforcement Results for Fiscal Year 2023, SEC Press Release 2023-234 (Nov. 14, 2023), available [here](#); Mengqi Sun, SEC’s Top Enforcer Says Tougher Penalties Are Working, Wall Street Journal (Dec. 29, 2023), available by subscription.

LATEST DEVELOPMENTS: ADVISERS

SEC Amends Rules Governing Beneficial Ownership Reporting

The SEC recently adopted amendments to the rules governing beneficial ownership reporting under Sections 13(d) and 13(g) of the Exchange Act and the Schedule 13D and Schedule 13G filing deadlines.

Schedule 13D

For Schedule 13D, the amendments shorten the initial filing deadline from 10 days to five *business* days after the date on which a person acquires beneficial ownership of more than 5 percent of a covered class. The amended rules also require that amendments to Schedule 13D be filed within two *business* days after the date on which a material change occurs, replacing the “promptly” standard that existed prior to the amended rules.

Schedule 13G

- For certain Schedule 13G filers (*i.e.*, qualified institutional investors and exempt investors), the amendments shorten the initial filing deadline from 45 days after the end of a calendar *year* to 45 days after the end of the calendar *quarter* in which the investor beneficially owns more than 5 percent of the covered class, as of the end of that quarter.
- For other Schedule 13G filers (*i.e.*, passive investors), the amendments shorten the initial filing deadline from 10 days to five *business* days after the date on which they acquire beneficial ownership of more than five percent of a covered class.
- For investors who become ineligible to file Schedule 13G in lieu of Schedule 13D, the amendments shorten the initial filing deadline for the Schedule 13D from 10 days to five *business* days after the event that causes the ineligibility.
- For all Schedule 13G filers, the amendments require that an amendment be filed 45 days after the calendar *quarter* rather than 45 days after the calendar *year* if, during that quarter, there were any *material* changes to the information previously reported rather than “any change” as previously required by the rules.
- The amendments accelerate the Schedule 13G amendment obligations for qualified institutional investors and passive investors when their beneficial ownership exceeds 10 percent or increases or decreases by 5 percent.
- The amendments also extend the filing “cut-off” times for Schedules 13D and 13G from 5:30 p.m. to 10:00 p.m. Eastern time.

Other Amendments

In addition to amending the filing deadlines, the SEC made a number of related amendments, including a requirement that filings use a structured, machine-readable data language (*i.e.*, XML-based language). The new rules also clarify the standard for determining when two or more persons may be considered a group that is required to report beneficial ownership of all equity securities owned by each member of such group. The SEC also provided question and answer guidance on the application of the current legal standard regarding formation of a group to certain shareholder engagement activities.

Compliance Dates

Compliance with the revised Schedule 13G filing deadlines will be required beginning on September 30, 2024. Compliance with the revised Schedule 13D filing deadlines will be required beginning on February 5, 2024. Compliance with the structured data requirement for Schedules 13D and 13G will be required beginning on December 18, 2024.

Source: *Modernization of Beneficial Ownership Reporting*, Release No. 33-11253 (Oct. 10, 2023), available [here](#).

SEC Publishes 38 New FAQs on Form ADV

The SEC recently published 38 new FAQs on Form ADV. The new FAQs supplement previously published FAQs on Form ADV and provide guidance on how advisers should respond to certain specific questions as well as how advisers should administratively handle certain special situations. The SEC’s guidance with respect to particular items on Form ADV includes the following:

- *Item 5.C.(1) and 5.D.* An adviser should count clients for whom the adviser provides investment advisory services, even if the adviser does not have any regulatory assets under management with those clients.
- *Item 5.K.(1), Schedule D.* Investments in ETFs should be classified as “securities issued by registered investment companies or business development companies” not as “exchange-traded equity securities.”

- *Item 7.B.(1)*. Advisers to newly created private funds should not report that a private fund's financial statements are subject to an annual audit if an auditing firm has not been engaged to conduct an audit for the applicable fiscal year.
- *Brochure, Part 2A, Item 2*. Advisers must identify **and discuss** material changes, providing only a list of material changes without a discussion of such changes is not sufficient.
- *Part 3*. Form CRS must be filed with an initial registration statement if an adviser intends to have retail investors as clients.

In addition to the disclosure-related items noted above, the updated FAQs provide guidance to advisers with respect to Form ADV filing matters, such as correcting errors and late filings, and other special situations.

Sources: *IM Information Update: Updates to Form ADV Frequently Asked Questions, IM-INFO-2023-02 (Oct. 26, 2023)*, available [here](#); *Frequently Asked Questions on Form ADV and IARD*, available [here](#).

DOL Proposes New Definition of Investment Advice Fiduciary and Amendments to PTE 2020-02

The Department of Labor (DOL) recently proposed the “Retirement Security Rule” redefining who is an investment advice fiduciary for purposes of the Employee Retirement Income Security Act (ERISA) and the Internal Revenue Code (Code). In addition, the DOL proposed amendments to Prohibited Transaction Exemption (PTE) 2020-02 (exemption), which many advisers rely on in connection with rollovers.

Proposed Definition of an Investment Advice Fiduciary

The DOL proposed a new definition of an investment advice fiduciary to replace the current five-part test established in 1975. As proposed, a person (including an adviser and its representatives) would be an investment advice fiduciary under ERISA and the Code if:

- They provide investment advice or make an investment recommendation to a retirement investor (for example, a plan participant or IRA owner);
- The advice or recommendation is provided for a fee or other compensation, and
- The advice or recommendation is provided in one of the following contexts:
 - The adviser has discretion over investment decisions for the retirement investor;
 - The adviser makes investment recommendations to investors on a regular basis as part of their business, and the recommendation is provided under “objective” circumstances indicating that the recommendation is based on the particular needs or individual circumstances of the retirement investor and may be relied upon by the retirement investor as a basis for investment decisions that are in the retirement investor's best interest; or
 - The adviser represents or acknowledges that they are acting as a fiduciary when making investment recommendations.

The proposed definition is DOL's most recent attempt to expand investment advice fiduciary status and likely will include all advisers and may extend to broker-dealers, insurance companies and banks, without any specific exclusions or safe harbors.

If every element of the proposed fiduciary definition is satisfied, it would apply to recommendations to rollover assets from a plan to an IRA (or vice versa) or IRA to IRA, even if they are one-time recommendations and even if they do not involve providing ongoing advice post-rollover.

The proposal would require investment advice fiduciaries to adhere to high standards of care and loyalty when they make investment decisions or recommendations and avoid decisions or recommendations that favor their financial and other interests at the expense of retirement investors.

Proposed Amendments to PTE 2020-02

Advisers relying on the existing exemption must:

- Adhere to the Impartial Conduct Standards, which require advisers to:
 - Give prudent advice that is in the “best interest” of the retirement investor (*i.e.*, based on the investment objectives, risk tolerance, financial circumstances, and needs of the retirement investor) without placing their own financial or other interests ahead of the retirement investor’s interests or subordinating the retirement investor’s interests to their own;
 - Charge no more than reasonable compensation; and
 - Avoid making materially misleading statements.
- Provide written disclosure to retirement investors including a fiduciary acknowledgment and a description of the adviser’s services and material conflicts of interest;
- Provide retirement investors with documentation of the specific reasons that a rollover recommendation is in their best interest;
- Maintain and enforce policies and procedures to ensure compliance with the Impartial Conduct Standards and mitigate conflicts of interest; and
- Conduct annual retrospective compliance reviews.

The proposed amendments to PTE 2020-02 would build on the existing conditions and:

- Amend the requirement to avoid making materially misleading statements to explicitly prohibit advisers and their representatives from omitting information that is needed to make the statement not misleading.
- Clarify the fiduciary acknowledgment requirement.
- Add new disclosure requirements, including with respect to the best interest standard of care, compensation, and rollovers.
- Prohibit the use of quotas, appraisals, performance or personnel actions, bonuses, contests, special awards, differential compensation, or other similar actions or incentives that are intended, or that a reasonable person would conclude are likely, to encourage recommendations that are not in retirement investors’ best interest.
- Require advisers, as part of their retrospective reviews, to correct any non-exempt prohibited transactions, file reports with the IRS, and pay any resulting excise taxes.
- Expand ineligibility to rely on the exemption to include affiliates’ crimes.
- Expand the availability of the exemption to robo-advice arrangements.

Public Hearings and Comments

The DOL held a virtual public hearing in December 2023, during which over 40 organizations testified representing both support and opposition to the controversial Retirement Security Rule. The Investment Company Institute (ICI) and other trade organizations urged the DOL to withdraw the proposed rule.

Comments were due January 2, 2024. More than 19,000 comments were received.

The Retirement Security Rule is expected to be finalized during the second quarter of 2024 in order to preempt the rule being overturned through the Congressional Review Act by the 119th Congress in 2025. If finalized, we expect it will be subject to legal challenges similar to those brought against the 2016 fiduciary rule, which was vacated by the Fifth Circuit Court of Appeals in 2018.

Sources: Retirement Security Rule: Definition of an Investment Advice Fiduciary, 88 Fed. Reg. 75890 (Nov. 3, 2023), available [here](#); Proposed Amendment to Prohibited Transaction Exemption 2020-02, 88 Fed. Reg. 75979 (Nov. 3, 2023), available [here](#); Investment Company Institute Comment Letter to the Department of Labor (Jan. 2, 2024), available [here](#).

Department of Treasury to Repropose AML Rule for Certain Advisers

On December 11, 2023, the U.S. Department of the Treasury (Treasury) released a Fact Sheet noting that Treasury expects to repropose provisions of its 2015 proposed rule under the Bank Secrecy Act. The release noted that Treasury is working to address the risks associated with advisers, which are not currently subject to comprehensive AML requirements. The new proposed rulemaking would apply AML/counter-terrorism requirements, including the completion of Suspicious Activity Reports, to certain advisers. Treasury aims to issue the proposed rule during the first quarter of 2024. For a discussion of the 2015 rule proposal, please see our [October 2015 Investment Management Legal and Regulatory Update](#).

Sources: U.S. Department of the Treasury Fact Sheet; U.S. Department of the Treasury Actions to Prevent and Disrupt Corruption (Dec. 11, 2023), available [here](#).

LITIGATION/ENFORCEMENT ACTIONS

Supreme Court review of Fifth Circuit decision in *Jarkesy v. United States*

The U.S. Supreme Court recently heard oral arguments challenging the SEC's in-house administrative law judges. The SEC had appealed the Fifth Circuit's 2022 ruling in *SEC v. Jarkesy*, which decision held that enforcement before the SEC's administrative law judge (ALJ) violated the right to a jury trial. The Fifth Circuit decision stands to limit the SEC's in-house enforcement authority as well as the enforcement powers of other federal agencies given the court's finding that "Congress unconstitutionally delegated legislative power to the SEC."

The SEC had brought an in-house enforcement action for securities fraud in 2013 against hedge fund manager George Jarkesy. The SEC pursued the action through an ALJ rather than a jury trial and the ALJ found Mr. Jarkesy liable for securities fraud and imposed various penalties, which the SEC upheld on appeal. Mr. Jarkesy filed a petition for review in the Fifth Circuit, which found that the SEC's proceedings were unconstitutional and vacated and remanded the decision.

During the oral arguments before the Supreme Court in November 2023, Chief Justice Roberts stated that it was "curious that and unlike most constitutional rights," an enforcement target was entitled to a trial by jury "until the government decides they don't want you to have it." Justice Gorsuch commented on the growth of the agency, observing that "this is not your grandfather's SEC." Justice Jackson inquired whether cases involving fraud (which resemble common lawsuits) should be adjudicated in federal courts. The Supreme Court's decision is expected to be issued prior to the Court's June 2024 recess.

Sources: Transcript of SEC v. Jarkesy Oral Argument, Doc. No. 22-859 (Nov. 29, 2023), available [here](#); Jarkesy v. SEC, No. 20-61007 (5th Cir., May 18, 2022), available [here](#).

COMPLIANCE DATES FOR FINAL RULES

Final Rules	Compliance Dates
Documentation of Adviser Compliance Reviews	November 13, 2023
Amendments to Form N-PX and Say-on-Pay Vote Disclosure	Rule and form amendments effective for votes occurring on or after July 1, 2023, with the first filings subject to the amendments due by August 31, 2024 for the 12-month period ended June 30, 2024.
Shareholder Reports, Rule 30e-3 Amendments and Amended Advertising Rules	Rule and form amendments are effective January 24, 2023, with a compliance date of July 24, 2024.
Private Fund Advisers Quarterly Statement Rule Private Fund Rule Adviser-Led Secondaries Rule, Restricted Activities Rule and Preferential Treatment Rule	March 14, 2025 March 14, 2025 Larger private fund advisers (\$1.5 billion or more in private fund assets): September 14, 2024 Smaller private fund advisers (less than \$1.5 billion in private fund assets): March 14, 2025
Investment Company Names	Larger fund groups (net assets of \$1 billion or more): December 10, 2025 Smaller fund groups (net assets of less than \$1 billion): June 10, 2026
Corporate Transparency Act	Subject entities in existence on January 1, 2024 must file an initial report by December 31, 2024. Entities created on or after January 1, 2024 must file an initial report within 30 days after receiving notice of their creation or registration.
Modernization of Beneficial Ownership Reporting*	Schedule 13D filing deadline: February 5, 2024 Schedule 13G filing deadline: September 30, 2024 Compliance with the structured data requirement: December 18, 2024

STATUS OF PROPOSED RULES

Proposed Rules for Funds and Advisers	Status
<u>Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices</u>	The SEC has indicated final amendments for rules and forms will be issued in April 2024.
<u>Cybersecurity Risk Management for Investment Advisers, Registered Investment Companies, and Business Development Companies</u>	The SEC has indicated final rules will be issued in April 2024.
Proposed Rules for Funds	Status
<u>Open-End Fund Liquidity Risk Management Programs and Swing Pricing; Form N-PORT Reporting</u>	The SEC has indicated final rules will be issued in April 2024.
Proposed Rules for Advisers	Status
<u>Outsourcing by Investment Advisers</u>	The SEC has indicated a final rule will be issued in April 2024.
<u>Safeguarding Advisory Client Assets</u>	The SEC has indicated final rules will be issued in April 2024.
<u>Regulation S-P: Privacy of Consumer Financial Information and Safeguarding Customer Information</u>	The SEC has indicated final amendments to Regulation S-P will be issued in April 2024.
<u>Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers</u>	The SEC has indicated final rules will be issued in April 2024.
Retirement Security Rule*	Comments were due January 2, 2024. The DOL likely will seek to finalize the rule during the second quarter of 2024.

*Discussion included in this IM Update.