SULLIVAN & CROMWELL LLP

S&C Quarterly
Investment Management Newsletter

Q1 2024

The S&C Quarterly Investment Management Newsletter highlights key legal and regulatory developments relevant to the investment management industry. For more information on these and other developments, we encourage you to reach out to your regular Sullivan & Cromwell contact.

Highlights

- In this issue we discuss key developments in Q1 2024, including certain rulemaking and legislative activities, SEC Staff guidance and no-action letters, disclosure updates, recent litigation and enforcement actions, and reports affecting the investment management industry.
- See our recent client alerts for more detailed discussions of recently finalized and proposed regulations relevant to the investment management industry, including the SEC's final rules on dealer registration, SPAC IPOs and de-SPAC transactions, and public company climate-related disclosures and the SEC's recent stay of those rules. These topics and more are also summarized below.
- At the end of this issue we preview the U.S. Department of Labor's Employee Benefits Security Administration's recently adopted final amendments to the "QPAM Exemption" and SEC EXAMS's recent Risk Alert on shortening of the securities transaction settlement cycle, each of which will be discussed in more detail in our upcoming Q2 2024 issue.

Recent Legislation and Rulemaking

SEC adopts rules further defining "as a part of a regular business" in the definition of dealer under the Exchange Act. On February 6, the SEC adopted Rules 3a5-4 and 3a44-2 to require certain proprietary trading firms, private funds and other market participants that take on significant liquidity roles in the market to register as dealers or government securities dealers for the purposes of the Exchange Act. The final rules represent a significant shift in determining whether a person was required to register as a dealer from a facts-and-circumstances test to a test solely focused on whether a person is providing liquidity to the market, which will capture certain market participants that had not been considered to be dealers previously. Under Rules 3a5-4 and 3a44-2, a person that is engaged in buying and selling securities or government securities for its own account is engaged in such activity "as a part of a regular business" and thus is required to register as a dealer or government securities dealer if that person engages in a regular pattern of buying and selling securities or government securities that has

the effect of providing liquidity to other market participants by: (1) regularly expressing trading interest that is at or near the best available prices on both sides of the market for the same security and that is communicated and represented in a way that makes it accessible to other market participants; or (2) earning revenue primarily from capturing bid-ask spreads, by buying at the bid and selling at the offer, or from capturing any incentives offered by trading venues to liquidity-supplying trading interest. The SEC emphasized, however, that the test set forth in the final rules is a non-exclusive way to determine whether a market participant was a dealer or government securities dealer and existing court precedents and SEC interpretations will continue to apply. Furthermore, the SEC exempted registered investment companies, persons owning or controlling less than $50 million in total assets, and central banks, sovereign entities or international financial institutions from registration. In response to comments regarding how "trading interests" applies to decentralized finance ("DeFi") markets, the SEC implied that persons using automated market makers in crypto asset markets, including in the DeFi market, could be dealers under the final rules depending on an analysis of the totality of the particular circumstances against all elements of the expressing trading interest factor test. Although narrower than initially proposed, the final rules remain broad, and outstanding questions remain regarding their scope and potential effect on market liquidity.

The National Association of Private Fund Managers, the Alternative Investment Management Association and MFA have filed a lawsuit to vacate the rule. These same associations challenged the securities lending and short-selling reporting rules in December 2023. For further information on the rules modifying the defintion of "dealer," please see our client memo here.

SEC and CFTC adopt amendments to Form PF. On February 8, the SEC and CFTC adopted amendments to Form PF, the confidential reporting form for certain SEC-registered investment advisers to private funds, including those also registered with the CFTC as commodity pool operators ("CPOs") or commodity trading advisors ("Form PF Filers"). The amendments will revise the General Instructions to require all Form PF Filers to separately report each component fund of a master-feeder arrangement and parallel fund structure (other than a disregarded feeder fund) and modify how private advisers report private "fund of fund" investments. The amendments will also require Form PF Filers to report additional information on the private funds they manage, including master-feeder arrangements, withdrawal and redemption rights, beneficial ownership, assets under management and fund performance. Form PF Filers are also required to report additional information on the hedge funds they advise, including investment strategies and counterparty exposures. The amendments also eliminate aggregate reporting for large hedge advisers (i.e., $1.5 billion or more AUM) and instead substantially expand the scope and granularity of information required to be reported by large hedge fund advisers on each hedge fund they advise with at least $500 million in AUM. Form PF Filers will be required to include more detailed reporting on investment exposure, open and large positions, borrowing and

counterparty exposure, significant counterparties, market factor effects, currency exposure reporting, turnover, country and industry exposure, risk metrics, investment performance by strategy, portfolio liquidity, and financing liquidity. The amendments are intended to aid the Financial Stability Oversight Council in monitoring systemic risk and enhance the regulatory oversight of investment advisers to private funds and investor protection. The compliance date for the amendments is March 12, 2025, which notably does not align with the compliance dates of the SEC Form PF amendments that were adopted in May 2023 and go into effect on June 11, 2024 (except for the amendments to Form PF sections 5 and 6, which went into effect on December 11, 2023).

SEC adopts amendments to the rule permitting certain internet investment advisers to register with the SEC (the "internet adviser exemption"). On March 27, the SEC adopted amendments to the internet adviser exemption, which permits certain internet investment advisers to register with the SEC. The amendments require any investment adviser that relies on the exemption to have an operational interactive website at all times, through which the adviser provides digital investment advisory services on an ongoing basis to more than one client. The amendments also eliminate the previously existing *de minimis* exception, requiring an internet investment adviser to provide advice to all of its clients exclusively through an operational interactive website. Internet advisers will also be required to include corresponding representations on their Form ADV. An adviser relying on the exemption must comply with the amendments by March 31, 2025. An adviser that is no longer eligible to use the amended internet adviser exemption and does not otherwise have a basis for registration with the SEC must withdraw its registration by filing a Form ADV-W by June 29, 2025.

In addition to the above, the adoptive release reaffirmed the Staff's position that extensions are not available under Rule 203A-2(c), which allows an adviser to register with the SEC if there is an expectation that it will be eligible for SEC registration within 120 days (the "120-day rule"). In October 2023, the Staff of the Division of Investment Management updated the FAQs for the Form ADV and for Item 2.A(9) to indicate that the 120-day rule does not provide for extensions, and that advisers that remain registered beyond such period should correct their registration eligibility by filing a Form ADV indicating a new basis for registration or withdrawing the registration via Form ADV-W.

SEC adopts rules imposing requirements on IPOs of SPACs and subsequent mergers/acquisitions involving SPACs and private operating companies ("de-SPAC transactions"). On January 24, the SEC adopted rules imposing requirements on IPOs of SPACs and subsequent de-SPAC transactions. The SEC also adopted new rules and amendments with respect to shell companies and blank check companies, including SPACs. The final rules require additional disclosures regarding the SPAC's sponsor, potential conflicts of interest, and dilution for SPAC IPOs as well as de-SPAC transactions. The final rules narrow the proposed fairness determination requirements to focus on

situations where such a determination is required by law in the jurisdiction where the SPAC is organized. The final rules also set forth new rules to align de-SPAC disclosures more closely with those for IPOs, including requiring the target in a registered de-SPAC transaction to be a "co-registrant" and an "issuer" such that the target will be required to begin filing reports after effectiveness of the de-SPAC registration statement, eliminating the PSLRA safe harbor, and requiring a post-de-SPAC company to re-determine its "smaller reporting company" status following the transaction. In addition, the final rules include enhanced projections disclosure requirements and provide that any business combination transaction involving a reporting shell company is deemed to involve a "sale" of securities to the shareholders of the shell company, subjecting the transaction to registration with the SEC regardless of whether securities are changing hands in the transaction.

There are certain topics on which the SEC declined to adopt proposed rules and instead chose to issue guidance. Specifically, the SEC declined to adopt proposed Rule 3a-10 under the 1940 Act, which would have provided a non-exclusive safe harbor from the definition of "investment company" for SPACs that meet certain conditions. Instead, the SEC provided guidance that generally aligned with the traditional *Toponah* factors. The SEC noted that if there is an extensive time period before a de-SPAC transaction distinguishing a SPAC's activities from those of an investment company may be harder, and in such circumstances recommended that a SPAC consider Rule 3a-2 of the 1940 Act (which provides a one-year safe harbor to so called "transient investment companies") and Rule 419 of the Securities Act (18 months). The SEC also declined to adopt proposed Rule 140a under the Securities Act, which would have deemed an underwriter in a SPAC IPO to be an "underwriter" in the de-SPAC transaction if it took "steps to facilitate the de-SPAC transaction, or any related financing transaction, or otherwise participates (directly or indirectly) in the de-SPAC transaction." Instead, the SEC provided guidance that even if the underwriter did not act in the same manner as a traditional underwriter in a traditional capital raising, depending on the facts and circumstances, a "statutory underwriter" may be deemed present where someone is selling for the issuer or participating in the distribution of securities in the combined company to the SPAC's investors and the broader public, Section 11 of the Securities Act would apply and such person will have liability for any material misstatement or omission in the registration statement.

The compliance date for the rules is July 1, 2024. For further information, please see our client update here.

California AG files legislation that would require "private equity groups" and "hedge funds" to provide written notice and obtain written consent prior to the acquisition of a healthcare facility or provider. On February 16, the California Attorney General and Assembly Speaker Pro Tempore introduced AB 3129, which would require "private equity groups" and "hedge funds" (each as defined in the legislation) to provide 90 days' written notice to and obtain written

consent from the AG prior to the acquisition of a healthcare facility or provider doing business in the state. The AG would have the power to: (i) extend the 90-day review period by 45 days; (ii) stay the review period if certain conditions are met; and (iii) grant, deny or impose conditions on a proposed acquisition if it is deemed to have anticompetitive effects or reduce access to healthcare. The notice and consent provisions would apply to purchases of assets and operations, changes in control over services or operations, and changes in voting control, in each case, on or after January 1, 2025. A private equity group or hedge fund would also be required to provide notice to, but not receive consent from, the AG for transactions involving nonphysician providers with an annual revenue of more than $4 million or physician providers consisting of two to nine providers with an annual revenue between $4 and $10 million. In addition, the legislation permits the AG to waive the notice and consent requirements if certain conditions are met, including that the target facility or provider cannot meet its debts and the change of control would ensure continued access to healthcare. AB 3129 would also restrict certain management services arrangements whereby a private equity group or hedge fund manages the affairs of a physician or psychiatric practice in exchange for a fee. The proposed legislation defines hedge funds and private equity groups broadly, such that the legislation, if enacted, would apply to a broad group of investors in the healthcare sector.

In 2022, California established the Office of Health Care Affordability ("OHCA"), and requires written notice of certain sales and transfers of control of healthcare entities be sent to OHCA, which may refer such transactions to the AG for review of anitcompetitive effects. In addition, nonprofit corporations that operate or control a healthcare facility or similar provider of services already have to obtain consent of the state AG prior to engaging in sale, transfer or other disposal of an asset or transfer of control. The proposed legislation, however, would expand the scope of AG oversight to the acquisition of any providers of healthcare services in the state of California by private equity groups and hedge funds.

Financial Crimes Enforcement Network ("FinCEN") proposes rule to extend Anti-Money Laundering ("AML") and Countering the Financing of Terrorism ("CFT") requirements to certain investment advisers. On February 13, FinCen proposed a rule to extend AML and CFT requirements to certain investment advisers to prevent hostile actors from exploiting the U.S. financial system. In the Department of Treasury's ("Treasury") 2024 Investment Adviser Risk Assessment, Treasury highlighted that hostile actors "access certain technology and services with long-term national security implications through investments in early-stage companies." In contrast to covered financial institutions, investment advisers are not subject to AML and CFT requirements imposed by the Bank Secrecy Act, which, according to Treasury, has caused hostile actors to seek out advisers who are not required to inquire into their source of money. The proposed rule would classify investment advisers as "financial institutions" and those

investment advisers registered with the SEC or those who qualify as exempt reporting advisers would be required to implement AML and CFT programs.

SEC proposes rule to adjust for inflation in defining a "qualifying venture capital fund" under section 3(c)(1) of the Investment Company Act. On February 14, the SEC proposed a rule that would adjust for inflation the dollar threshold used in defining a "qualifying venture capital fund" under Section 3(c)(1) of the Investment Company Act. The proposed rule would update the dollar threshold to $12 million in aggregate capital contributions and uncalled committed capital, from the current standard of $10 million. The proposed rule is intended to implement the directive in the Economic Growth, Regulatory Relief, and Consumer Protection Act of 2018, which requires the SEC to index the dollar figure for this threshold to inflation once every five years. The proposed rule would also establish a procedure for future adjustments.

Recent SEC Staff Guidance and No Action Letters

SEC provides responses to the FAQs for calculating gross and net performance under the Marketing Rule. On February 6, the Staff of the Division of Investment Management updated its responses to questions stemming from amendments to the 2020 Marketing Rule. Specifically, the Staff confirmed that under the Marketing Rule, the calculation of the gross and net performance shown in advertisements must always be based on the same time period, return and methodology, and must be presented in a format designed to facilitate comparison of net performance with gross performance. Additionally, the Staff clarified that investment advisers may not include a Gross Internal Rate of Return ("IRR") that is calculated from the time an investment is made (without factoring in subscription facilities) and also display a Net IRR that is calculated from the time investor capital is called to repay the borrowing because such a presentation would result in IRR calculations that use different methodologies and time periods, and such calculations would not facilitate comparison.

SEC publishes FAQs for tailored shareholder reports. On January 17, the SEC Division of Investment Management published answers to FAQs related to the Mutual Funds and Exchange-traded Funds Tailored Shareholder Reports Rule and form amendments adopted in October 2022, which require such funds to provide shareholder reports that "highlight key information that is particularly important for retail investors to assess and monitor their fund investments." The SEC included an 18-month transition period for covered funds to comply, with the compliance date of July 24, 2024. The Staff FAQs provide responses to questions in the following categories: Appropriate Broad-Based Securities Market Index; Form N-CSR and Website Availability Requirements; Binding Individual Shareholder Reports of Multiple Funds; Electronically Provided Shareholder Reports; and Compliance Date and Inline XBRL Issues. For further information about the Tailored Shareholder Reports rule and form amendments, please see our client memo here.

Disclosure Updates

SEC adopts rules to expand climate-related disclosures in periodic reports and registration statements for certain issuers, including business development companies ("BDCs"), real estate investment trusts ("REITs") and exchange-traded products. On March 6, the SEC adopted rules to expand the climate-related disclosures in SEC periodic reports and registration statements for U.S. public companies and foreign private issuers, including BDCs and other registered collective investment vehicles but not asset-backed securities issuers. Though the SEC has removed or narrowed some of the more onerous proposed requirements (including Scope 3 reporting), the final rules still prescribe expansive climate-related disclosures. After publishing the proposed rules in 2022, the SEC received several comment letters recommending that BDCs be exempted from the rules, as they are pooled investment vehicles that are more similar to registered investment companies than companies with operations. In the adopting release for the final rules, the SEC explained that BDCs and other registered collective investment vehicles may face material climate-related risks that would impact an investment or voting decisions and thus should be subject to the final rules. Further, the SEC noted that BDCs have limited disclosure obligations to the extent climate-related risks are not material. Different groups have filed legal challenges to the final rules since their adoption. On March 21, the challenges filed in six different circuit courts were consolidated for review by the U.S. Court of Appeals for the Eighth Circuit. On April 4, the SEC issued an order staying the rules pending the completion of judicial review of these consolidated challenges. For more on the SEC Final Climate-Related Disclosure Rules, see our memo here and for more on the SEC Stay Order, see our client update here.

Recent Litigation and Enforcement Actions

SEC fines Delphia (USA) Inc. and Global Predictions Inc. $400,000 to settle charges for making false and misleading statements about their use of AI. On March 18, the SEC announced it settled charges with two advisers, Delphia (USA) Inc. and Global Predictions Inc., for allegedly making false and misleading statements about their use of AI, known as "AI washing." According to the SEC order, from 2019 to 2023, Delphia (USA) Inc. made false and misleading statements in its SEC filings, in a press release, and on its website about the use of AI to incorporate client data in its investment process, and in 2023, Global Predictions Inc. made false and misleading claims on its website and on social media, including that its platform provided "[e]xpert AI-driven forecasts." In both instances, the SEC alleged that the firms misled the public by fraudulently claiming that they used AI, when in fact they did not, in violation of the SEC's Marketing Rule. Delphia (USA) Inc. agreed to pay a $225,000 penalty and Global Predictions Inc. agreed to pay a $175,000 penalty to resolve the matter. These actions follow the Investor Alert issued on January 25, 2024 by the SEC's Office of Investor Education and Advocacy about artificial intelligence and investment fraud.

SEC fines HG Vora Capital Management LLC ("HG Vora") $950,000 to settle charges for failing to make timely ownership disclosures. On March 1, the SEC announced it settled charges with HG Vora for allegedly failing to make

timely ownership disclosures in connection to its May 2022 acquisition bid for Ryder System Inc. ("Ryder"). Under the beneficial ownership provisions of the federal securities laws, a stockholder that owns more than five percent of a company's stock must report its position and whether it has a control purpose. According to the SEC order, HG Vora disclosed that it owned 5.6 percent of Ryder's stock as of December 31, 2021, and certified that it did not have a control purpose. HG Vora then increased the ownership amount to 9.9 percent and formed a control purpose no later than April 26, 2022. HG Vora was thus required to report its current ownership position and control purpose on Schedule 13D by May 6, but it did not report this information until May 13. HG Vora agreed to pay a $950,000 penalty to resolve the matter.

SEC fines 16 firms over $81 million to settle charges for failing to preserve electronic communications. On February 9, the SEC announced it settled charges with 16 firms, including broker-dealers, investment advisers and dually registered advisers, for allegedly failing to preserve electronic communications. According to the SEC order, between 2019 and 2024, the firms' employees used unapproved communication methods like personal text messages, known as off-channel communications, to discuss business. The firms did not preserve the majority of these off-channel communications, in violation of certain recordkeeping provisions under the Exchange Act and the Investment Advisers Act. In failing to maintain records, the SEC claimed that the firms likely deprived SEC investigations of these off-channel communications. However, the SEC emphasized that one firm received a significantly lower penalty because the firm voluntarily cooperated and self-reported. The firms collectively agreed to retain independent compliance consultants and pay over an $81 million penalty to resolve the matter.

SEC fines J.P. Morgan Securities LLC ("JPMS") $18 million to settle charges for violating Rule 21F-17(a) of the Exchange Act. On January 16, the SEC announced it settled charges with JPMS for allegedly inhibiting hundreds of advisory clients and brokerage customers from reporting potential securities laws violations to the SEC in violation of Rule 21F-17(a) of the Exchange Act, a whistleblower protection rule that prohibits hindering an individual from communicating directly with the SEC about possible violations. According to the SEC order, between March 2020 and July 2023, JPMS asked clients to sign confidential release agreements that required the client to keep the settlement, all underlying facts relating to the settlement, and all information relating to the account at issue, confidential. In addition, while the agreements permitted clients to respond to SEC inquiries, they did not allow clients to voluntarily contact the SEC. JPMS agreed to pay an $18 million penalty to resolve the matter.

Reports

U.S. Department of Treasury releases report on managing artificial intelligence-specific cybersecurity risks in the financial services sector. On March 27, Treasury released a report on managing artificial intelligence-specific cybersecurity risks in the financial services sector. The report is based on 42 in-

depth interviews with representatives from the financial services sector, IT companies, data providers and anti-fraud/AML companies. In the report, Treasury identifies best practices for managing artificial intelligence-specific cybersecurity risks and opportunities and challenges that artificial intelligence presents to the financial services sector, including, among others, developing an artificial intelligence risk management framework, the evolution of the Chief Data Officer role and the data supply chain, key questions for vendors, the application of cybersecurity best practices and addressing the growing capability gap between large institutions developing their own artificial intelligence systems and smaller institutions that are unable to do so. The report does not impose requirements or endorse or discourage the use of artificial intelligence within the financial services sector.

Recent Developments

U.S. Department of Labor's Employee Benefits Security Administration adopts final amendments to the "QPAM Exemption." On April 2, 2024, the U.S. Department of Labor's Employee Benefits Security Administration adopted final amendments to the "QPAM Exemption" that will result in an expansion of the events that disqualify entities from relying on the widely used exemption, causing significant complications for impacted institutions. The Class Prohibited Transaction Exemption 84-14, also known as the Qualified Professional Asset Management Exemption, permits certain parties related to employee benefit plans and individual retirement accounts ("IRAs") to engage in transactions involving IRAs and plan assets. The final amendments specifically: (1) clarify that foreign convictions are included in the scope of the exemption's ineligibility provision beyond criminal convictions to include entering into NPAs and DPAs in criminal investigations; (2) expand the ineligibility provision to include additional types of serious misconduct; (3) add a one-year transition period that focuses on mitigating potential costs and disruptions to plans and IRA owners; (4) update asset management and equity thresholds; (5) clarify the requisite independence and control a Qualified Professional Asset Manager must have with respect to investment decisions and transactions; and (6) add a recordkeeping requirement.

The Staff at SEC EXAMS issues risk alert on the shortening of the securities transaction settlement cycle. The Staff of the SEC's Division of Examinations' ("EXAMS") recently issued a Risk Alert on the shortening of the securities transaction settlement cycle from two business days after the trade date to one business day, which will go into effect on May 28, 2024, and the related FAQs published by the Staff of the Division of Trading and Marketing and of Investment Management about the amended standard settlement cycle, including broker-dealer affirmation requirements, and investment adviser recordkeeping requirements. The Risk Alert provides additional information about the scope and content of EXAMS's review and assessment of registrants' preparedness associated with the shortening of the settlement cycle and related final rules.

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