SULLIVAN & CROMWELL LLP

S&C Quarterly Investment Management Newsletter

Q2 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 Q2 2024, including recent Supreme Court and appellate court decisions, certain rulemaking and legislative activities, recent enforcement actions, risk alerts and key updates in the EU affecting the investment management industry.
- See our recent client alerts for more detailed discussions of key Supreme Court decisions in the commercial sphere, the Fifth Circuit's decision vacating the Private Fund Adviser Rule and the U.S. Department of Labor's Employee Benefits Security Administration's recently adopted final amendments to the "QPAM Exemption."
- The SEC recently published its Spring 2024 Reg-Flex Agenda, as part of the Unified Agenda of Regulatory and Deregulatory Actions released by the Office of Management and Budget's Office of Information and Regulatory Affairs (the "Spring 2024 Agenda"). The Unified Agenda is a government-wide, semi-annual publication that lists proposed and final rules that the agencies plan to issue in the next six to 12 months, as well as in the long term. The Spring 2024 Agenda sets forth an "October 2024" date for the finalization of a number of key rules affecting the investment management industry, including previously proposed rules relating to cybersecurity risk management, Regulation Best Execution and outsourcing by investment advisers. The Spring 2024 Agenda also includes an October 2024 date for the reproposal of a handful of pending rules, including Safeguarding Advisory Client Assets (the previously proposed amendments to the existing Custody Rule) and Conflicts of Interest Associated with the Use of Predictive Data Analytics, and an April 2025 date for the reproposal on Open-End Fund Liquidity Risk Management Programs (including swing pricing). Although the Spring 2024 Agenda provides insights into the SEC's current rulemaking priorities, it is non-binding on the SEC and the indicated timelines often do not correlate with the actual agency action dates. It remains to be seen whether the SEC will move forward with some of the adoptions in light of the recent Supreme Court and appellate decisions discussed below.

Recent Supreme Court and Appellate Decisions

***Loper Bright* / *Relentless*: Supreme Court overrules *Chevron* deference.** On June 28, the U.S. Supreme Court overruled the doctrine of *Chevron* deference—a practice whereby courts are required to defer to an agency's interpretation of an ambiguous statute that the agency is charged with implementing so long as that interpretation is reasonable—in the companion cases of *Loper Bright Enterprises* v. *Raimondo* and *Relentless, Inc.* v. *Dep't of Commerce*. Instead, the Court held that courts are obligated to exercise their independent judgment in determining the

meaning of a statute and whether an agency has acted within its statutory authority. Notably, overruling *Chevron* does not open up for reexamination all previous cases decided under "step two" of the *Chevron* regime because the Court stated that prior decisions upholding agency interpretations will still be subject to *stare decisis*, even if courts had invoked *Chevron* in those cases to defer to the meaning offered by the agency. The Supreme Court noted that it had not defered to an agency interpretation under *Chevron* since 2016.

After *Loper Bright*, agencies will have to hew more closely to the statutes they interpret, and cannot reverse positions once a court has decided the best reading of the statute. Courts may still give weight to agency views, but that weight will vary under the doctrine of *Skidmore* deference, which remains good law. Under *Skidmore* deference, the weight a court may ascribe such agency's "judgment in a particular case" would "depend upon the thoroughness evident in [the agency's] consideration, the validity of its reasoning, its consistency with earlier and later pronouncements, and all those factors which give it power to persuade, if lacking power to control."[1] *See* our memo on *Loper Bright* and our annual Supreme Court Business Review for more information.

***Jarkesy*: Supreme Court rules that SEC cannot bring securities-fraud claims for civil penalties before an in-house adjudicator.** On June 28, in *Securities and Exchange Commission* v. *Jarkesy*, the Supreme Court held that, absent the defendant's consent, the SEC must bring securities-fraud actions seeking civil penalties before a federal court, rather than before the agency's in-house adjudicators. In the Dodd-Frank Act, Congress authorized the SEC to enforce the antifraud provisions of the Securities Act, the Exchange Act and the Advisers Act by initiating an enforcement action before the SEC in a proceeding that does not involve a jury and may result in the imposition of civil penalties. After Dodd-Frank, the SEC began to use in-house adjudicators or administrative law judges in certain enforcement proceedings. On a challenge to one such SEC enforcement action against George Jarkesy, the Court held that the jury-trial right extends to statutory claims that resemble common-law causes of action, and, in particular, pursue remedies traditionally available at common law. Because civil penalties were a remedy traditionally available at common law and securities fraud also resembles common-law fraud, the Seventh Amendment was implicated.

While the SEC can no longer bring fraud claims in front of an in-house adjudicator if it intends to seek civil penalties, whether other remedies, such as disgorgement, trigger the Seventh Amendment and the application of the Court's decision to other federal agency statutes remain open questions. For more on the case, please see our client memo and our annual Supreme Court Business Review.

***Corner Post*: Supreme Court rules that time limitations for judicial review of federal agency action under the APA accrue on the date the plaintiff is first injured.** On July 1, the Supreme Court held in *Corner Post* v. *Board of Governors of*

[1] *Skidmore v. Swift & Co.*, 323 U.S. 134 ,139-140 (1944).

the Federal Reserve that an “aggrieved” party’s right to challenge an agency action under the Administrative Procedure Act (“APA”) accrues under 28 U.S.C. § 2401(a), the general statute under which to bring a lawsuit against the United States, on the date the plaintiff was first injured by the rule, which (as was the case with *Corner Post*) may occur more than six years after the rule’s adoption. *Corner Post* opens the door to challenges to long-standing agency rules by parties that have only recently been affected by those rules, such as newly formed businesses. It remains to be seen whether such challenges will succeed, particularly when rules have previously been upheld against an APA challenge and *stare decisis* applies. In addition, given that the Advisers Act and the Investment Company Act contain time limitations for aggrieved parties to challenge agency “Orders,” the extent to which *Corner Post* will affect the investment management industry is currently unclear. *See* our annual Supreme Court Business Review for more information.

Fifth Circuit vacates the Private Fund Advisers Rule. On June 5, in *National Association of Private Funds Managers* v. *Securities and Exchange Commission*, the Fifth Circuit held that the SEC exceeded its authority under Sections 211(h) and 206(4) of the Advisers Act in adopting the Private Fund Advisers Rule. The Private Fund Advisers Rule, adopted by the SEC in August 2023, imposed enhanced disclosure requirements on private fund advisers and restricted a broad range of investment activities within the private funds industry. In a unanimous opinion of a three-judge panel, the Fifth Circuit vacated the Private Fund Advisers Rule in full.

In reaching its decision, the Fifth Circuit held that the SEC’s authority under Section 211(h) is limited to “retail customers” and—perhaps more impactful to the SEC’s rulemaking authority—that to promulgate rules under Section 206(4) the SEC is required to articulate a “rational connection” to fraud and explain how such rules are designed to prevent fraud. Despite the SEC’s statements that the Private Funds Advisors Rule was designed to prevent fraud, the court vacated the rule because the Commission failed to articulate a “rational connection” or “close nexus” between fraud and any part of the rule. Further, the opinion notes that Section 206(4) does not authorize the SEC to require disclosure or reporting, limiting the tools at the SEC’s disposal to address the activities of investment advisers.

The Fifth Circuit’s narrow reading of SEC’s authority under both Section 211(h) and 206(4) could restrict the agency’s future rulemaking and provide grounds for industry participants to challenge a number of the SEC’s proposed rules that, if finalized as proposed, rely on these provisions of the Advisers Act. For further information on the Fifth Circuit’s decision, please see our client memo here.

Recent Legislation and Rulemaking

NYSE proposes exemption for closed-end funds from annual shareholder meeting requirement. On June 6, the New York Stock Exchange ("NYSE") filed a proposal with the SEC to amend Section 302.00 of the NYSE Listed Company Manual to exempt closed-end funds ("CEFs") from the requirement to hold an annual shareholder meeting. Currently, CEFs are only required to hold annual shareholder meetings pursuant to the rules of national securities exchanges, such as NYSE and Nasdaq; the Investment Company Act and state laws applicable to trusts in jurisdictions where most CEFs are organized (i.e., Delaware, Maryland, and Massachusetts) do not impose the requirement. In its proposal, NYSE states that it is appropriate to exempt CEFs from the annual shareholder meeting requirement because the Investment Company Act contains significant protections for CEF shareholders (e.g., director election provisions and limitations on the proportion of interested directors on the board) that shareholders of public operating companies do not have. Further, NYSE notes that Section 302.00 already explicitly exempts all other categories of investment companies for which the NYSE has listing standards. Finally, NYSE reasons that Section 6(b) of the Securities Act supports eliminating the annual shareholder meeting requirement because it "remove[s] impediments" to a free and open market given that the Investment Company Act's protections are sufficient to protect investors.

President Biden vetoes joint Congressional resolution disapproving SEC Staff Accounting Bulletin on accounting obligations for safeguarding crypto-assets. On May 31, President Biden vetoed H.J. Res. 109, a joint resolution providing for congressional disapproval of the SEC Staff Accounting Bulletin No. 121 ("SAB 121"), which was released on March 31. SAB 121 provides accounting and disclosure guidance related to certain Exchange Act registrants' and certain other covered entities' obligations to safeguard crypto-assets held in custody for their customers. Specifically, the bulletin requires these entities to record the fair market value of the crypto-asset on their balance sheet alongside a corresponding liability. In letters to the SEC and public statements, a number of members of Congress noted that SAB 121 would discourage banks from providing custodial services to digital asset investors at scale by making such services prohibitively expensive. On Wednesday, July 10, a vote on whether to override President Biden's veto failed in the U.S. House of Representatives. In her testimony prior to the House vote, Representative Maxine Waters said the SEC and the banking industry are in talks on modifications to the accounting policy.

The SEC and Financial Crimes Enforcement Network ("FinCEN") propose rule requiring certain investment advisers to implement customer identification programs ("CIPs"). On May 13, the SEC and FinCEN proposed new rules requiring registered investment advisers ("RIAs") and exempt reporting advisers ("ERAs") to implement CIPs, similar to procedures implemented by other financial institutions (e.g., banks, mutual funds and broker-dealers) to verify the identities of their customers each time they open a new account. Notably, for private fund advisers, the term "customer" would capture each fund and related entity for which the adviser provides services, but not the underlying fund investors. If adopted, the rules would

require covered advisers to: (1) collect certain customer identification information; (2) establish risk-based procedures for the verification of the identity of each customer within a reasonable time either before or after the opening of an account; (3) retain certain records; and (4) implement systems for determining if a customer appears on a list of known or suspected terrorists.

The proposed rule complements the February 2024 FinCEN proposal, which, if adopted, would expand the definition of "financial institutions" under the Bank Secrecy Act to cover RIAs and ERAs. The SEC and FinCEN are soliciting comments on the proposed rule through July 22, 2024. If adopted, registered investment advisers are expected to implement CIPs in the six months following the effective date of the final rule.

U.S. Department of Labor's Employee Benefits Security Administration adopts final amendments to the "QPAM Exemption." As previewed in our Q1 Newsletter, on April 2, 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 Final Amendment went into effect on June 17, 2024 but provides a one-year transition period from its effective date, during which a QPAM can assess if it continues to satisfy the QPAM Exemption and clients can amend or exit arrangements with a QPAM. For more information on the Final Amendment to the QPAM Exemption, please see our client memo here.

Recent Enforcement Actions

SEC fines Catalyst Capital Advisors LLC ("Catalyst") for entering into an impermissible joint legal fee arrangement with its mutual fund client. On April 29, the SEC announced it settled charges with RIA Catalyst for allegedly entering into an improper joint legal fee arrangement with its client Mutual Fund Trust Series (the "Trust"), an SEC-registered open-end investment company. According to the SEC order, without the knowledge or consent of the Trust's independent trustees, Catalyst avoided paying legal fees from May 2017 to March 2020 by improperly arranging for (1) the Trust and Catalyst to be represented by the same legal counsel, and (2) the Trust to, at least initially, pay the legal fees and expenses stemming from regulatory inquiries and private litigation after the Catalyst Hedged Future Strategy Fund, a series of the Trust, experienced significant losses. The engagement letter with legal counsel acknowledged that conflicts of interest might develop between Catalyst and the Trust but did not address how expenses would be allocated between the two entities for joint services. The SEC order found that Catalyst violated Section 17(d) of the Investment Company Act and Rule 17d-1, which prohibits joint transactions between registered investment companies and any of their affiliates who are acting as a principal, and Section 206(2) of the Advisers Act. Catalyst agreed to a cease-and-desist order, censure, disgorgement of $280,902 (of which $183,757 was offset by a previous payment to the Trust), prejudgment interest of $30,081 and a civil penalty of $200,000 to resolve the matter.

SEC settles charges with five RIAs for Marketing Rule Violations. On April 12, the SEC announced settled charges against GeaSphere LLC, Bradesco Global Advisors Inc., Credicorp Capital Advisors LLC, InSight Securities Inc. and Monex Asset Management Inc. for violating the Advisers Act's Marketing Rule. Under the Marketing Rule, RIAs are prohibited from including hypothetical performance in their advertisement unless the adviser adopts and implements policies and procedures reasonably designed to ensure that the performance is relevant to the likely financial situation and investment objectives of the advertisement's intended audience. In adopting the Marketing Rule, the SEC observed that advisers generally would not be able to include hypothetical performance in advertisements directed to a mass audience because of the general inability to tailor the advertisement to each audience member's financial situation or investment objectives. The SEC found that the five firms advertised hypothetical performance on their websites to the mass public without adopting or implementing the appropriate policies and procedures. All five firms have agreed to settle the charges and pay penalties ranging from $20,000 to $100,000 per firm. Firms that took corrective steps prior to being contacted by the SEC staff received reduced penalties. This is the second set of cases that the SEC has brought as part of an ongoing targeted sweep concerning Marketing Rule violations after charging nine advisory firms in September 2023.

The SEC settles charges with standalone RIA for failures to maintain and preserve electronic communications. On April 3, the SEC announced it settled charges with Senvest Management LLC ("Senvest") for failing to maintain and preserve electronic communications in violation of the Advisers Act's Recordkeeping Rule. Notably, this is the first off-channel communications settlement with a standalone private fund adviser that is not affiliated with a broker-dealer since the SEC launched its investigative sweeps focused on off-channel communications in 2022. Unlike broker-dealers, which are required to preserve all communications related to a firm's business, standalone private fund advisers are only required to maintain records on certain enumerated categories of written information. Between January 2019 and December 2021, Senvest employees used personal platforms to communicate about firm business and failed to preserve these off-channel communications in violation of both the Recordkeeping Rule and the firm's policies and procedures. Senvest admitted the facts set forth in the SEC's order, acknowledged that its conduct violated federal securities laws, and agreed to pay a $6.5 million penalty and to implement improvements to its compliance policies and procedures. The SEC's settlement order implies that Senvest's failure to follow its own policies and procedures and to supervise its employees' compliance with stated firm policies strengthened the SEC's case against the Adviser, given the more narrow requirements applicable to standalone advisers.

SEC EXAMS

SEC EXAMS issues Risk Alert on Advisers Act Marketing Rule compliance. On April 17, the EXAMS Staff issued a Risk Alert sharing preliminary observations from examinations of investment advisers' compliance with the Marketing Rule. The Risk Alert highlights EXAMS's continued focus on investment advisers' compliance with Marketing Rule items contained in Form ADV, the Compliance Rule, the Books and

Records Rule and the Marketing Rule's general prohibitions. The Alert also highlights observations and recent deficiencies with respect to each of the aforementioned rules, including instances where advisers' policies and procedures were not reasonably designed or implemented to ensure compliance with the rules, resulting in gaps for preventing deficiencies. The Alert also discusses Marketing Rule-related deficiencies on advisers' Form ADVs, including inaccurate statements related to the advisers' advertisements.

SEC EXAMS issues Risk Alert on the shortening of the securities transaction settlement cycle. As previewed in our Q1 Newsletter, the EXAMS Staff 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 went 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.

European Union: Key Updates

The EU's European Supervisory Authorities (the "ESA") issues a joint opinion on the Sustainable Finance Disclosure Regulation (the "SFDR"). On June 18, the Boards of Supervisors of the ESA published a joint opinion in response to the European Commission's September 2023 consultations, which are part of a wider assessment of SFDR framework. The SFDR is an EU regulation that aims to improve sustainability disclosures of financial market participants' investment policies. The opinion states that the current disclosure regime set out in Articles 8 and 9 of the SFDR, which refer to financial products that promote "environmental or social characteristics" and products that make "sustainable investments," respectively, have been used as "'quality labels' for sustainability" by financial market participants, creating confusion for investors and posing "greenwashing and mis-selling risks." The ESA recommends replacing the current practice of categorization in Articles 8 and 9 with two new categories based on minimum criteria: (i) a sustainable product category for products that invest in economic activities/assets that are already environmentally and/or socially sustainable; and (ii) a transition product category for products that invest in economic activities/assets that are not yet sustainable but which improve their sustainability over time to become environmentally or socially sustainable. The ESA also recommends limited disclosure and disclaimer requirements for financial products that would not qualify for these categories, based on whether the financial products have sustainability features. For more on the ESA opinion, see our June ESG Newsletter here.

ESMA issues final funds' names guidelines. On May 14, the European Securities and Markets Authority ("ESMA") published its final report setting forth guidelines on funds' names using ESG or sustainability-related terms. The guidelines provide that a minimum of 80% of investments by funds with sustainability-, transition-, social-,

governance-, environmental-, or impact-related terms must meet environmental or social characteristics or sustainable investment objectives in accordance with their investment strategy. In addition, depending on their strategy, the funds will be required to comply with the exclusion criteria in either the EU Paris-aligned Benchmarks or the EU Climate Transition Benchmarks. Sustainability-related funds will be required to commit to investing meaningfully in sustainable investments referred to in the Sustainable Finance Disclosure Regulation. The guidelines will apply to management companies for funds registered in EU countries under the Undertaking for Collective Investment in Transferable Securities ("UCITS funds") and will come into effect three months after their publication in all official EU languages on ESMA's website, with funds predating such date having six months to come into compliance with the guidance. These guidelines are similar to other rules recently adopted by other regulators, such as the SEC and FCA.

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