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Investment Management

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Regulatory Update and Recent SEC Actions

REGULATORY UPDATES

RECENT SEC ADMINISTRATION CHANGES

Tina Diamantopoulos Named Regional Director of Chicago Office

The Securities and Exchange Commission ("SEC"), on May 16, 2024, announced that Tina Diamantopoulos was named the Director of the Chicago Regional Office. Ms. Diamantopoulos began her SEC career with the Enforcement Division in the Chicago office in 1994. Over the last 30-years with the SEC, she has held leadership roles in both the Division of Enforcement and Division of Examinations. She earned her law degree from Northwestern Pritzker School of Law and her bachelor's degree from Marquette University.

SEC to Close Salt Lake Regional Office

The SEC, on June 4, 2024, announced that it will close its Salt Lake Regional Office ("SLRO") later this year. The SLRO's enforcement jurisdiction over Utah will be moved to the SEC's Denver Regional Office and regional examination authority will be unaffected by the closure.

RECENT SUPREME COURT DECISIONS IMPACTING THE SEC

SEC v. Jarkesy

In a 6-3 split decision, the U.S. Supreme Court upheld a Fifth Circuit ruling that found the SEC's use of its in-house judicial forum when there are potential civil penalties violated the Seventh Amendment. The June 27, 2024, opinion holds that a defendant has a right to a jury trial in federal court when financial penalties are potentially imposed. The ruling is considered to be a landmark decision and its implications are considerable, including its potential impact on the use of administrative tribunals by the SEC and other agencies to enforce civil penalties and potential to cause the SEC to be more selective in bringing enforcement actions.

Loper Bright Enterprises, Inc. v. Raimondo,* and *Relentless, Inc. v. Department of Commerce

In a 6-3 split decision, the U.S. Supreme Court reversed the Court's 1984 landmark decision in *Chevron v. NRDC* and concluded that administrative agencies, such as the SEC, do not receive deference in interpreting the statutes that govern the agencies' work. The Court explained, "In an agency case as in any other, though, even if some judges might (or might not) consider the statute ambiguous, there is a best reading all the same—'the reading the court would have reached' if no agency were involved." Moreover, "[i]t therefore makes no sense to speak of a 'permissible' interpretation that is not the one the court, after applying all relevant interpretive tools, concludes is best." This decision may have important implications on the SEC's ability to maintain and create new rules in emerging areas, such as cybersecurity; cryptocurrency; and environmental, social, and governance ("ESG").

SEC RULEMAKING

SEC Adopts Rule Amendments to Enhance Protection of Customer Information

The SEC, on May 16, 2024, adopted amendments to Regulation S-P, which governs the treatment of consumers' personal information. These amendments seek to modernize the rule to address the expanded use of technology and changes in practices since the original adoption of Regulation S-P in 2000. The amendments require a covered institution (which includes broker-dealers, investment companies, registered investment advisers, and transfer agents) to implement and maintain written policies and procedures that are reasonably designed to detect and respond to unauthorized access to, or use of, customer information. The amendments will become effective on August 2, 2024. In general, entities will have 18 or 24 months from the publication to comply with the amendments.

Department of the Treasury and the SEC Jointly Issue a Proposed Rulemaking Implementing Customer Identification Programs for Registered Investment Advisers and Exempt Reporting Advisers

The SEC and the Department of the Treasury's Financial Crimes Enforcement Network (FinCEN) on May 13, 2024, jointly proposed a rule (the "Proposed Rule") that would require SEC-registered investment advisers ("RIAs") and exempt reporting advisers ("ERAs") (collectively, "Advisers") to establish, document, and maintain written customer identification programs. The Proposed Rule would require the Advisers to implement policies and procedures reasonably designed to give them a reasonable belief that they have the true identity of their customer and maintain those records. The Proposed Rule would allow the Advisers to rely on other financial institutions to perform the customer identification programs but would require a written agreement that is reasonable under the circumstances. Next, the agreement must be with another financial institution that is regulated by a federal regulator and is required to maintain an anti-money laundering/counter-terrorist financing program under the Bank Secrecy Act. Finally, the Adviser must require that the other institution to certify annually to the Adviser that it will perform the specific requirements of the customer identification programs. The comment period on the Proposed Rule will close on July 22, 2024.

SEC Issues Exemptive Order Providing Additional Time for Certain Registrants to File Quarterly Reports in Light of BF Borgers Permanent Suspension

The SEC, on May 20, 2024, provided exemptive relief to certain registrants affected by the permanent suspension of accounting firm BF Borgers PCA PC and its owners (collectively, "BF Borgers"). The SEC has suspended BF Borgers from appearing and practicing before the SEC as an accountant. Those registrants who have previously retained BF Borgers will need to engage a new, independent PCAOB-registered public accountant to audit and review the financial information to be included in SEC filings. As a result, the SEC has provided additional time for the filing of quarterly and transition reports on Form 10-Q for issuers that have filed a timely Form 12b-25 notifying the Commission of their inability to file a report on a timely basis.

Fifth Circuit Vacates Private Fund Rule

The U.S. Court of Appeals for the Fifth Circuit (the "Court"), on June 5, 2024, vacated the new private funds rules (the "Rule") adopted by the SEC on August 23, 2023. The Rule made significant changes to the operation of private fund advisers, which prompted a group of private fund managers, in September 2023, to file a petition against the SEC claiming that the SEC exceeded its statutory authority. In a unanimous decision, the three-judge panel concluded the SEC did exceed its statutory authority and vacated the Rule in its entirety.

The New York Stock Exchange Proposed Rule Changes to Exempt Registered Closed-End Funds from the Annual Meetings Requirement

The New York Stock Exchange ("NYSE"), on June 6, 2024, filed an application under the Securities Exchange Act of 1934 (the "Exchange Act") to amend the NYSE Listed Company Manual such that closed-end funds ("CEFs") listed on the NYSE would not have to hold an annual shareholder meeting during each fiscal year. The application stated that the Investment Company Act of 1940 provides significant shareholder protections that are not afforded to public operating companies and, as a result, it is appropriate to exempt CEFs from their annual shareholder meeting requirement. On June 12, 2024, the Cboe BZX Exchange, Inc. filed a similar rule amendment exempting CEFs from its annual shareholder meeting requirement.

SEC ENFORCEMENT ACTIONS AND OTHER CASES

SEC Charges Registered Investment Adviser with Recordkeeping and Other Failures

The SEC, on April 3, 2024, announced charges against a registered investment adviser (the "Adviser") for widespread and longstanding failures to maintain and preserve certain electronic communications and failing to enforce its code of ethics. The Adviser admitted to the facts in the SEC's order, acknowledging that its conduct violated the Investment Advisers Act of 1940 (the "Advisers Act") and that it failed to reasonably supervise employees.

According to the SEC's order, the Adviser's employees, at various levels of seniority, communicated about company business internally and externally through personal means of communication in violation of Adviser's policies and procedures. Further, the Adviser failed to preserve the off-channel communications as required by the Advisers Act and the firm's policies and procedures.

"The Commission continues to focus on regulated entities' compliance with the recordkeeping requirements. Adherence to these requirements is essential for the Commission to effectively exercise its regulatory oversight and enforce the federal securities laws," said Eric Werner, Director of the Fort Worth Regional Office.

SEC Wins in Civil Law Suit Based on Novel Theory of Insider Trading

In a recent case *(SEC v. Panuwat),* a civil jury issued a verdict in favor of the SEC, which had alleged that the senior director of business development ("Defendant") at a publicly traded biopharmaceutical company engaged in "shadow trading." Shadow trading, which is prosecuted under Rule 10b-5 of the Exchange Act, occurs when an individual trades in the securities of one company based on the material nonpublic information of another company whose securities the individual does not trade.

The Defendant, based on his position in the company, received information that there was an imminent deal for his company to be sold to a larger pharmaceutical company. Shortly after receiving this communication, the Defendant began buying call options in a similarly sized biopharmaceutical company. Because the Defendant knew that his company had been fielding offers for sale, he knew that there were larger companies looking to buy a company with similar qualities as his. A jury found him guilty of violating Rule 10b-5.

It is important to highlight that this was a civil action, and the burden of proof that the SEC had to meet was lower than that of a criminal case. However, the SEC's success in this civil case may open the door to criminal prosecutions under the shadow trading theory of insider trading.

SEC Charges Five Investment Advisers for Marketing Rule Violation

The SEC, on April 12, 2024, announced that it settled charges against five registered investment advisers (the "Advisers") for violating Rule 206(4)-1 under the Advisers Act (the "Marketing Rule"). The SEC's orders found that all the firms advertised hypothetical performance to the general public without adopting and implementing policies and procedures reasonably designed to comply with the Marketing Rule. Specifically, the Advisers did not ensure the hypothetical performance was relevant to the financial situation and investment objectives of each advertisement's intended audience. One of the Advisers violated additional regulatory requirements, including making false and misleading statements in advertising, advertising misleading model performance, failing to substantiate performance highlighted in the advertisement, and failing to enter into written agreements with individuals who were compensated for endorsements.

"The Marketing Rule's provisions are crucial to protecting investors from misleading advertising claims," said Corey Schuster, Co-Chief of the SEC Enforcement Division's Asset Management Unit. "Today's actions show that we will continue to employ targeted initiatives to ensure that investment advisers fully comply with their obligations under the rule. They also serve as a reminder of the benefits to firms that take corrective steps before being contacted by Commission staff."

Supreme Court Holds that Failure to Disclose Information Required by Regulation S-K Cannot Support a Private Action

The U.S. Supreme Court, on April 12, 2024, released an opinion addressing whether the failure to disclose information required by Item 303 of SEC Regulation S-K can support a private action under Rule 10b-5(b) of the Exchange Act. The Court unanimously ruled that a failure to disclose certain information about its future business risks cannot itself be the basis of a private securities fraud claim. The Court held that silence alone is not misleading under Rule 10b-5(b). Instead, silence may be misleading and give rise to a private action under Rule 10b-5(b) "if the omission renders affirmative statements made misleading."

SEC Charges Registered Investment Adviser and the Firm's Founder for Failing to Disclose Conflicts of Interest

The SEC announced, on May 14, 2024, that it settled charges against a New York-based registered investment adviser (the "RIA") and its founder ("Founder") for breaching their fiduciary duties by failing to disclose conflicts of interests and making misleading statements to their clients. Over a four-year period, the RIA advised a private investment fund

and the RIA's individual clients to invest in films produced by a particular film production company. The Founder, through an affiliated company, received $530,000 from the production company as a fee for the money invested by the fund and the individual clients. The RIA and Founder failed to disclose these payments to the clients and then misrepresented to clients that the payment was for work as an executive producer on the films.

SEC Charges International Exchange Service Provider and Nine Affiliates with Failing to Inform the Commission of a Cyber Intrusion

The SEC announced, on May 22, 2024, that a multinational financial services company (the "Company") agreed to pay a $10 million penalty to settle charges that it caused failure of nine wholly owned subsidiaries to timely inform the SEC of a cyber intrusion, as required by Regulation Systems Compliance and Integrity ("Regulation SCI"). In April 2021, a third-party informed the Company that the Company was potentially impacted by a system intrusion in the Company's virtual private network ("VPN"). The Company determined that a threat actor had inserted malicious code into a VPN device but failed to notify the legal and compliance officials at the Company's subsidiaries until several days later. As a result, the subsidiaries were unable to fulfill their regulatory disclosure obligations under Regulation SCI.

SEC Charges Advisory Firm and Co-Founder and CEO with False Statements and Undisclosed Conflicts

The SEC, on May 29, 2024, engaged in settlement proceedings with a formerly registered investment adviser (the "Adviser"), its co-founder, and CEO (the "CEO") for making false and misleading statements to investors in the Adviser's fund. The Adviser was charged with violating the antifraud and compliance provisions of the Advisers Act and the CEO was charged with violating the antifraud provisions of the Advisers Act. According to the SEC's orders, the CEO allegedly made false statements about underlying portfolio data which was then included in investor communications. The communications included its monthly tear sheets, summary portfolio snapshots, and top 10 position lists.

SEC Charges Private Company and Its Founder with Fraudulent Scheme to Manipulate the Stock Price of a Public Company

The SEC, on May 31, 2024, announced charges against a private company (the "Company") and its founder ("Founder") in connection with a fraudulent scheme to manipulate the stock price of a publicly held company ("PublicCo"). The SEC's complaint alleges that, after building a position in the PublicCo's stock and options, the Company and Founder began issuing press releases calling upon PublicCo to sell itself or to add Founder to its board of directors in an unsuccessful effort to drive up the price. Subsequently, Founder allegedly devised a new plan in which he announced a phony buyout offer through a press release, saying that the Company proposed to buy all outstanding stock of PublicCo for nearly twice the prior day's closing price.

SEC Charges Three Individuals for Raising More than $184 Million through Pre-IPO Fraud Schemes

The SEC, on June 7, 2024, announced fraud charges against three individuals (the "Defendants") for selling unregistered membership interests in LLCs to gain investments in shares of pre-IPO companies. The SEC alleged that the Defendants led an unregistered sales force of more than 50 individuals to make calls to pressure investors into making investments without informing them that the shares had been marked up substantially and that, subsequently, the Defendants misappropriated more than $45 million from investors from 2019 to 2022.

SEC Charges CEO and Founder of AI Startup with Fraud

The SEC, on June 11, 2024, announced charges against a CEO and founder (the "Defendant") of an AI startup (the "Company") for defrauding investors of $21 million. The SEC's complaint alleges that the Defendant made false and misleading statements about the nature of the Company's customer base, the number of candidates on its platform, and the Company's revenue. The Defendant allegedly told investors that the Company had more than 100 customers, including *Fortune* 500 companies, and provided fabricated testimonials from companies praising the Company's effectiveness. Upon suspicion from an investor, the Defendant allegedly provided falsified bank statements and forged contracts to conceal the fraud.

SEC Charges Investment Firm and Its Founder with Defrauding Investors

The SEC, on June 12, 2024, announced charges against an investment adviser (the "Adviser") and its Founder and Chief Investment Officer (the "Founder") for a three-year scheme to defraud investors of at least $3 million. The SEC's complaint alleges that the Adviser raised $3 million from nine investors by fabricating every aspect of an equity fund, including its performance, investment activity, and investment risks. Additionally, the Adviser and Founder spent at least $1.1 million of the money on personal expenses and lost more than $1.7 million on high-risk trading and speculative investments. The complaint further alleges that the Adviser falsified documents to conceal trading losses from investors.

SEC Charges Global Communications Service Provider with Cybersecurity-Related Controls Violations

The SEC, on June 18, 2024, announced a settlement agreement with a global provider of business communication and marketing services (the "Defendant"), after bringing disclosure and internal control failure charges related to cybersecurity alerts and incidents. According to the complaint, the Defendant's security personnel were responsible for monitoring the network's security but failed to design effective disclosure controls and procedures to report relevant cybersecurity information to management. Additionally, the Defendant allegedly failed to carefully assess and respond to alerts of unusual activity in a timely manner. Finally, the Defendant allegedly failed to create and maintain a sufficient system of cybersecurity-related controls to provide reasonable assurance that access to the Defendant's assets were only available with management's authorization.

Healthcare Company Founder Convicted in Novel Insider Trading Case

The U.S. Department of Justice ("DOJ"), on June 21, 2024, prevailed in a trial where the jury found a healthcare company (the "Company") and its founder and former CEO (the "Defendant") guilty on three counts of insider trading. The Defendant is the first executive to be criminally charged exclusively based on a Rule 10b5-1 trading plan. 10b5-1 plans allow insiders to set up a recurring investment plan to avoid the potential misperception of trading on material, nonpublic information. The DOJ contended that the Defendant engaged in a Rule 10b5-1 trading plan scheme where he sold $20 million of shares in the Company after discovering that the Company's biggest client (the "Client") at the time, intended to terminate their agreement. This scheme allowed the Defendant to avoid nearly $12.5 million in losses. The Defendant asserted during the trial that he was advised by his management team that there was no material nonpublic information at the time he devised his trading plans and that his motivation for trading was his desire to exercise expiring warrants, pay off some loans, and purchase a house. A week before the Client informed the Company about its intent to end the agreement, the Defendant certified his first trading plan in which he sold hundreds of thousands of shares daily. A month later, the Defendant set up his second Rule 10b5-1 trading plan, a few days before the Client's intent to end its agreement became public, which led stock prices to plummet more than 45 percent. The Defendant was convicted for making false representations to promote the trading plan and selling his shares in both plans.

SEC Charges Company and Former CEOs with Market Manipulation and Fraud

The SEC, on June 25, 2024, filed charges against a Nevada corporation (the "Company") and the two former CEOs (the "CEOs") of the entities that merged to form the Company. The complaint alleged that the Company raised $137.5 million from investors in an at-the-market ("ATM") offering in June 2021 immediately prior to the merger. The SEC alleges that the CEOs issued a preferred stock dividend before the merger and hinted on social media that the divided would trigger a "short squeeze" that would raise the Company's stock price. Further, the complaint alleges that the CEOs capitalized on investors' reaction to the news by selling $137.5 million in an ATM offering when the CEOs knew the price was temporarily inflated by their manipulative scheme.

OTHER INDUSTRY HIGHLIGHTS

SEC Staff Publishes New Registered Fund Statistics Report

On April 18, 2024, the SEC published a report on registered fund statistics using Form N-PORT Data from October 2022 through September 2023. The fund statistics only include those funds that are required to file on Form N-PORT: mutual funds (excluding money market funds), exchange-traded funds ("ETFs"), closed-end funds (including interval funds and non-traded funds registered on Form N-2), and separate accounts offering variable annuity contracts on Form N-3. The report shows that from October 2022 to September 2023, nearly 100 new funds were formed. Over that same period, there was an increase in total assets of $1.5 trillion. With both statistics, nearly half of each increase is attributable to mutual funds and the other half to ETFs.

For additional information and assistance, contact Thomas R. Westle, Stacy H. Louizos, or another member of Blank Rome's Investment Management Group.

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