U.S. Regulatory Update

June 2023

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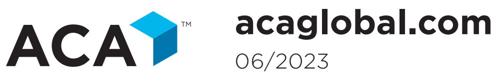


Introduction

Welcome to our June regulatory updates where you will find practical thought leadership distilling the latest regulatory headlines. For all firms this month, we highlight the SEC's latest risk alerts on weak branch office procedures and on the LIBOR transition, the biggest whistleblower award ever, and new state regulations related to privacy and financial exploitation of seniors and other vulnerable investors. For advisers, we share key takeaways from recent Form PF amendments and for broker-dealers, we break down a recent case of Regulation Best Interest (Reg BI) failures. Finally, we share our "lessons learned" from recent enforcement activity and suggested resources for your additional research.

All Firms

Better than the Lottery! SEC's Largest Whistleblower Award.

by Jaqueline Hummel

A whistleblower received the largest award in the history of the SEC's program, raking in $279 million. This most recent award is more than double the eye-popping $114 million awarded in October 2020. SEC-registrants beware – these extraordinary awards provide massive incentives for future whistleblowers.

Are You Ready to Transition from LIBOR to SOFR?

by Jaqueline Hummel

The London Interbank Offering Rate (LIBOR), developed by the British Banker's Association in the 1980s and used globally as a benchmark interest rate for financial contracts, is going away. **The United Kingdom's Financial Conduct Authority** confirmed that all U.S. dollar LIBOR settings will cease to be provided after June 30, 2023. The **Federal Reserve's Alternative Reference Rates Committee (AARC)** recommended the Secured Overnight Financing Rate (SOFR) as the preferred alternative to LIBOR. In a **prior risk alert**, the SEC's Division of Examinations (EXAMS) (then known as the Office of Compliance Inspections and Examinations) warned that it would be reviewing firms' preparations for the expected discontinuation of LIBOR. This latest alert discusses what EXAMS found during these examinations.

The alert focuses on five areas: risk management, operations, portfolio management, fiduciary responsibilities and investor communications, and information gathering on the latest transition challenges. To manage transition risks, firms formed cross-functional LIBOR working groups to draft transition plans and impact assessments. Firms have also either joined or relied on the guidance provided by AARC and participated in industry group discussions. Internal training and guidance describing the firm's plans for the transition are also a significant component of firms' risk management processes.

At the operational level, firms engaged with service providers, sub-advisers, and third-party managers through due diligence questionnaires and outreach to determine their readiness for the LIBOR transition. Some firms engaged in extensive testing to determine whether their systems could handle alternative reference rates. EXAMS noted that several firms developed a rigorous reconciliation process to ensure that the alternative reference rates could be properly accounted for by counterparties and service providers.

On the portfolio management side, firms assessed LIBOR exposure across subsidiaries or affiliates, tracking and monitoring LIBOR and alternative reference rate exposure. EXAMS also noted that firms proactively identified contracts that may be more difficult to transition and implemented internal controls, such as pre-trade compliance checks and trading restrictions for new and legacy LIBOR-linked instruments.

To meet their fiduciary obligations, firms reviewed potential conflicts of interest and developed comprehensive disclosures because of the transition. Conflicts related to the transition include cross and principal trades, allocation of transition costs, and clients with conflicting priorities. Communication and engagement strategies were also implemented to keep clients informed about how firms were preparing for the transition away from LIBOR.

EXAMS observed that firms continue to monitor the AARC and other industry resources for guidance and tools on LIBOR transition issues that are not easily solved. In a welcome change, EXAMS focused on the many positive actions firms took to prepare for the transition to SOFR. Firms still working on their LIBOR transition should consider adopting some of the practices discussed in this alert.

Risk Alert on Safeguarding Customer Records and Information at Branch Offices.

by Cari Hopfensperger

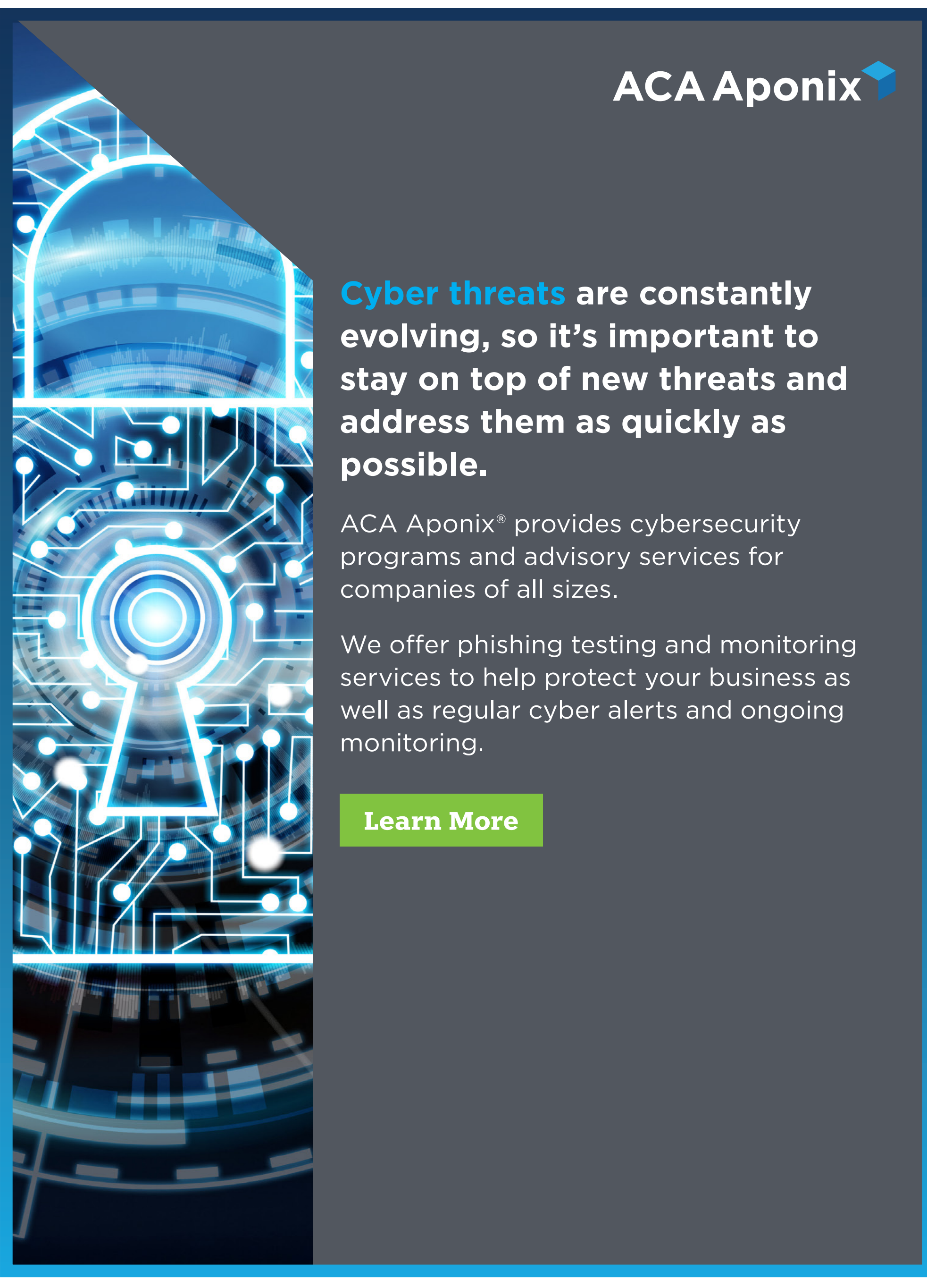
The SEC Division of Examinations (EXAMS) recently published a risk alert calling attention to weaknesses in broker-dealer and investment adviser branch office policies and procedures to safeguard client information. Regulation S-P requires brokers and advisers to “adopt written policies and procedures that address administrative, technical, and physical safeguards for the protection of customer records and information.” The crux of this risk alert is that while many firms with multiple office locations have adopted reasonable policies and procedures to address their home office activities, they have failed to do so in their branch offices. The alert breaks down these gaps into the following categories:

- **Vendor Management** – When firms use a business model that allows branch offices to select their own vendors, EXAMS observed weaknesses in branch office vendor selection and oversight practices as well as a lack of training, guidance, standards, and other information provided by home offices to assist branch offices with their responsibilities. Firms should consider their approach to branch office vendor management during their overall review of service provider oversight policies and procedures.

- **Email Configuration** – When firms permit branch offices to use different email systems from the home office, EXAMS noted branch office weaknesses here as well. Firms should carefully consider the additional risks associated with this approach and the controls that can help them properly mitigate and manage those risks. Specifically, firms should address branch office configurations and technical requirements in their policies and procedures and ensure that the technical requirements are sufficient for the firm to properly conduct its incident response procedures if needed.

- **Data Classification** – EXAMS observed firms with a reasonable process to classify their data as electronic records in its home office but failed to follow those same procedures or leverage the same controls for data classification in its branch offices. As a result, those firms failed to properly identify and control customer records and information. When firms utilize different approaches or controls in branch offices (such as due to the existence of different types of risk in branch offices), those should also be reflected in firm policies and procedures.
- **Access Management** – EXAMS' observations in this category centered on differences between home and branch office requirements pertaining to password complexity and the use of Multi-factor Authentication (MFA). Again, in some firms, appropriate policies and procedures were implemented in their home office, but not in branch offices.
- **Technology Risk** – EXAMS noted firms with reasonable policies and procedures to address technology management practices for inventory management, patch management and vulnerability management at their home office, but a lack of awareness by home offices of the systems being used in branches. As a result, branch offices with outdated patching and end-of-life operating systems eluded detection by home office oversight. Once again, firms that allow branch offices to maintain their own systems should consider applying their home office standards to branch office systems if possible or setting specific minimum standards for branches, and then reviewing them for compliance periodically.

While it may sound straightforward to suggest that firms simply impose the same standards, procedures, and controls on home and branch offices, the reality is that may not be so simple. In particular, firms using an independent contractor model may struggle with practically resolving these gaps, especially when the independent contractor is also operating a separate business that may be subject to differing regulatory expectations and/or business considerations as an accountant and/or insurance agency. However, this alert makes clear that the SEC is expecting firms to demonstrate how they consider safeguarding-related risks in the context of home and branch office activities. Firms should consider this holistically – including how branch office expectations are addressed in firm policies and procedures, whether and how to impose minimum standards, providing guidance and training to assist its branch offices in meeting their responsibilities, and finally, providing oversight of branch office compliance with the firm's expectations.



Indiana, Tennessee, and Montana Adopt Comprehensive Privacy Laws

by Cari Hopfensperger

The Indiana Consumer Data Protection Act (ICDA) (**Senate Enrolled Act No. 5**) was signed into law May 1, followed shortly thereafter by the Tennessee Information Protection Act (TIPA) (**H.B. 1181)** on May 11th and the Montana Consumer Data Privacy Act (MCDPA) (**S.B. 384**) on May 19th. Indiana, Tennessee, and Montana join California, Colorado, Connecticut, Iowa, Virginia, and Utah, the six other states with comprehensive privacy laws. While ICDA, TIPA, and MCDPA share similarities with other state privacy laws, there are also differences. Before getting into the weeds, however, firms should consider the applicability of each rule to their business and whether an exemption applies. For starters, SEC-registered firms already subject to Title V of the GLBA are likely not subject to ICDA, TIPA, or MCDPA. State-registered firms and exempt reporting advisers (ERAs) could also be out of scope if they do not meet the other criteria, which are summarized on the next page.

Applicability		
ICDA	**TIPA**	**MCDPA**
ICDA applies to persons that conduct business in Indiana or produces products or services that target Indiana Residents that:	TIPA applies to companies that conduct business in Tennessee or produce products or services that target Tennessee residents, and that:	MCDPA applies to persons that conduct business in Montana or persons that produce products or services that are targeted to residents of Montana and:
– Control or processes personal data of at least **100,000** consumers who are **Indiana** residents, ***or***	– Exceed **$25 million** in annual revenue, ***and***	– Control or process the personal data of not less than **50,000** consumers, excluding personal data controlled or processed solely for the purpose of completing a payment transaction, ***or***
– Control or processes personal data of at least **25,000** consumers who are Indiana residents and derive more than **fifty percent (50%)** of its gross revenue from the sale or personal data	– Either (1) control or process personal information of at least **25,000** consumers and derive more than **fifty percent (50%)** of gross revenue from the sale of personal information or (2) during a calendar year, control or process personal information of at least **175,000** consumers.	– Control or process the personal data of not less than **25,000** consumers and derive more **than twenty five percent (25%)** of gross revenue from the sale of personal data.
"Consumer" means an individual who (1) is an Indiana resident, and (2) is acting only for a personal, family or household purpose. The term does not include an individual acting in a commercial or employment context.	"Consumer" means a natural person who is a Tennessee resident "acting only in a personal context" and does not include a natural person acting in a commercial or employment context.	"Consumer" means an individual who is a Montana resident and does not include an individual acting in a commercial or employment context.
Key Exemptions		
Any financial institutions and affiliates, or data subject to Title V of the federal Gramm-Leach-Bliley Act (15 U.S.C. § 6801 et seq.)	A financial institution, an affiliate of a financial institution, or data subject to Title V of the federal Gramm-Leach-Bliley Act (15 U.S.C. § 6801 et seq.)	Financial institution or an affiliate of a financial institution governed by, or personal data collected, processed, sold, or disclosed in accordance with, Title V of the Gramm-Leach-Bliley Act (15 U.S.C. 6801, et seq.)
Effective Date		
January 1, 2026	July 1, 2025	October 1, 2024

For additional research, the law firm of Husch Blackwell maintains a **privacy blog**, a handy **State Privacy Law Tracker**, and **this table**, which compares the main features of each state privacy law. Firms in scope for TIPA, or MCDPA should consider if their information security program and privacy policies, procedures, and privacy notices will satisfy the requirements under these new laws and plan accordingly for implementation.

Georgia Enacts Broker-Dealer and Investment Adviser Financial Exploitation Law

by Cari Hopfensperger

On May 3rd, Georgia became the latest state to enact a new senior investor exploitation law that grants civil and administrative immunity to firms, acting in good faith and satisfying certain conditions, that delay disbursements or transactions from the account of a senior or vulnerable investor when fraud is suspected. **Georgia Senate Bill 84** is effective July 1, 2023. Georgia also requires broker-dealers and investment advisers (state and SEC-registered firms) to report suspected financial exploitation. The law firm of Bressler Amery and Ross sponsors a comprehensive **Senior and Vulnerable Investor Issues Map** that outlines the various state financial exploitation laws. It has not yet been updated to reflect the Governor's signing of SB 84 into law but is a useful research tool. For additional resources on the Senior Safe Act and state financial exploitation laws, check out the Worth Reading section below.

Investment Advisers

It Could Have Been Worse: More Reporting for Private Fund Advisers as SEC Amends Form PF

by Jaqueline Hummel

The SEC **adopted amendments to Form PF** on May 3rd. The headline is that hedge and private equity fund advisers will be expected to report certain material events to the SEC, including investment losses over 20% of a fund's net asset value (NAV), change in a fund's prime brokers, and redemption requests exceeding 50% of a fund's NAV. The following are highlights of the amendments. Please see the **final release** for the details.

Which Firms must Report?

- Large hedge fund advisers, meaning those with at least $1.5 billion in hedge fund assets under management.
- Private equity fund advisers, meaning those advisers with at least $150 million in private equity fund assets under management.
- Large private equity fund advisers, meaning those advisers with at least $2 billion in private equity fund assets under management.

Which Events Must be Reported?

- **Reportable Events for Large Hedge Fund Advisers.** Reporting required on Section 5 of Form PF, in the Private Fund Reporting Depository (PFRD) as soon as practicable, but no later than, 72 hours of these triggering events occurring:
  - Extraordinary investment losses, defined as losses of more than 20% of a fund's reporting fund aggregate calculated value (RFACV) over a period of ten business days.
  - Margin and default events
    - An increase in the total dollar value of a reporting fund's margin requirements, collateral or equivalent, of 20% or more of RFACV within a rolling 10-business-day period.
    - A fund's margin default or failure to meet a margin call, collateral, or equivalent.
    - Counterparty default where the amount is greater than 5% of RFACV.
  - Change in Prime Brokerage Relationship
    - The prime broker terminates or materially restricts its relationship with the reporting fund in markets where the prime broker continues to be active.
    - The prime brokerage relationship is terminated by either party and a "termination event" was activated in the prime brokerage agreement within the last 12 months.
  - Operations Events
    - Any "significant disruption or degradation" of a reporting fund's "critical operations," defined as operations necessary for "(1) the investment, trading, valuation, reporting, and risk management of the reporting fund; or (2) the operation of the reporting fund in accordance with the Federal securities laws and regulations."
  - Large Withdrawal and Redemption Requests
    - Cumulative requests for withdrawals or redemptions equal to 50% or more of NAV.
    - Reporting fund is unable to pay redemption requests or has suspended redemptions, and the suspension lasts for more than five consecutive business days.

- **Quarterly Event Reporting for Private Equity Fund Advisers**: Private equity fund advisers will be required to file quarterly reports if "Reportable Events" occur. Events should be reported on new Section 6 of Form PF through PFRD within 60 days of a fund's fiscal quarter end.
  - Reportable Events
    - Adviser-led secondary transactions, defined as "any transaction initiated by the adviser or any of its related persons that offers private fund investors the choice to: (1) sell all or a portion of their interests in the private fund; or (2) convert or exchange all or a portion of their interests in the private fund for interests in another vehicle advised by the adviser or any of its related persons."
    - The limited partners vote to (i) remove the fund's adviser or affiliate as the general partner, (ii) terminate the fund's investment period, or (iii) terminate the fund.
- **Annual Reporting Items for Large Private Equity Fund Advisers**: Large private equity fund advisers (with at least $2 billion in private equity AUM) must answer new questions in Section 4 of Form PF.
    - Question 82 asks adviser to disclose the implementation of any general partner clawback, or a limited partner clawback (or clawbacks) exceeding 10% of a fund's aggregate capital commitments.
    - Questions requesting disclosure about:

Form PF Question	**Topic**
66 (new question)	Investment strategies
67 (enhanced question)	Country exposure based on NAV
68 (new question)	Fund-level borrowings (including credit available and average amount borrowed over the reporting period)
77 (enhanced question)	Portfolio company events of default
78 (enhanced question)	Identification of institutions providing bridge financing

These amendments for current event reporting for hedge fund advisers and the quarterly reporting for private equity fund advisers go into effect six months after the publication of the adopting release in the Federal Register, and the remaining amendments (annual reporting) become effective one year after publication in the Federal Register.

For large hedge fund advisers, these changes will require new monitoring processes for the triggering events and a new threshold, RFACV, to be calculated. Private equity fund advisers will also need to set up protocols for monitoring and reporting quarterly reportable events. Large private equity fund advisers have a year to prepare answers to the new questions on Form PF. The SEC's stated goal for the amendments is to enhance the ability of the Financial Stability Oversight Counsel "to address systemic risk and to bolster the Commission's oversight of private fund advisers and its investor protection efforts." The end result, however, may be even more scrutiny of private fund advisers.

Broker Dealers

FINRA's First Expulsion for Firm's Reg BI Failures

by Jaqueline Hummel

FINRA used its regulatory hammer against a **broker-dealer** and its **CEO** in its first case expelling a firm for Regulation Best Interest (Reg BI) violations. The member firm failed to disclose compensation, churned customer accounts, and failed to supervise. (See FINRA's first disciplinary action citing Reg BI **here.**) According to the Letter of Acceptance, Waiver, and Consent (AWC), the firm told investors that it would receive a 10% commission for the sale of certain pre-IPO securities, when, in fact, the firm would receive an additional five percent selling commission and half of any carried interest received by the issuer. The firm's registered representatives were highly motivated and sold interests in the private placement to a total of 171 investors, including 163 retail investors. The firm received about $2 million in undisclosed compensation. To make matters worse, the firm did not conduct due diligence on the offering. Therefore, it had no reasonable basis for recommending it to investors, violating its obligations under both Reg BI and FINRA's suitability rule. Finally, two of the firm's registered representatives engaged in churning in nine customer accounts. Churning occurs when there is excessive trading in customer accounts without considering their investment goals. Despite red flags, the firm failed to follow up on the excessive trading in those accounts, causing at least one retired customer to lose most of his retirement savings.

Because of these failures, the firm was expelled from FINRA. Additionally, the firm's owner and CEO was suspended for nine months in any capacity, followed by an additional three-month suspension from acting in any principal capacity and personally fined $50,000.

Broker-dealers should expect intense focus on compliance with Reg BI. Bill St. Louis, Executive Vice President and Head of FINRA's National Cause and Financial Crimes Detection Program, told SIFMA's Compliance and Legal conference in March 2023 that FINRA plans to complete at least 1,000 Reg BI examinations of broker-dealers by year-end[1]. In addition to firm examinations, it is important to note that FINRA continues to conduct Reg BI investigations and Form CRS reviews through its other programs. Firms should have written procedures along with well-documented supervision of sales activities and training to ensure that registered representatives are complying with Reg BI.

[1]This 1,000 exam target refers to the cumulative number of firm exams since the June 30, 2020 compliance date for Reg BI.

Lessons Learned

Trustees Caught in the Crosshairs in Liquidity Rule Violations Case

by Cari Hopfensperger

The SEC recently filed a complaint against a mutual fund adviser and several of its trustees in the first case enforcing the Investment Company Act's **liquidity Rule** (Rule 22e-4). In addition to this complaint, the SEC recently settled with one trustee for their role in the violations. Before diving into the facts of the case, here is a brief overview of the Liquidity Rule. Originally adopted in October, 2016, **Rule 22e-4** (the Liquidity Rule) requires open end funds (including ETFs) to establish liquidity risk management programs intended to ensure that funds maintain sufficient liquidity to meet daily shareholder redemptions and to minimize the impacts of daily flows on existing shareholders. Key components of the Liquidity Rule include: (1) assessment, management, and periodic review of a fund's liquidity risk; (2) classification of portfolio holdings into one of four predefined liquidity buckets ranging from "illiquid" up to "highly liquid"; (3) no more than 15% of the fund's NAV may be invested in "illiquid" investments, and (4) board oversight of the liquidity risk management program administrator's activities. More specifically, when illiquid investments exceed 15% of a fund's NAV, a fund must file Form N-LIQUID (since renamed as **Form N-RN**) which includes disclosure of the fund's plan to return the concentration of the fund's illiquid investments below the 15% level.[1]

In this case, the fund owned a concentrated position in a private placement investment. On June 1, 2019, (the initial compliance date for the Liquidity Rule) the fund's illiquid holdings comprised approximately 23.5% of its NAV. Dating back to the 2016 adoption of the Liquidity Rule, legal counsel began advising the fund and its adviser to prepare for implementation of a newly required liquidity risk management program, to classify this investment as illiquid, to prepare for an eventual N-LIQUID filing, and to develop an approach to bring the concentration of illiquid investments down below the 15% threshold. However, the trustee did not take these steps. Although the investment was restricted from resale, the fund's legal counsel advised the adviser to classify this holding as "illiquid", and the investment was reported on the audited financials and in shareholder reports as an illiquid security, the trustee counseled the board and the adviser to classify this security as "less liquid". As a "less liquid" security, the fund appeared to avoid the requirement to file Form N-LIQUID and formulate a plan to reduce its concentration in illiquid investments. Post-Liquidity Rule, the SEC questioned the fund, asking how it would address illiquid positions in the portfolio and how it planned to reduce the concentration of such holdings going forward. Again, the fund's legal counsel and auditor urged the trustee and adviser to classify this security as illiquid. The fund continued to reject this advice on multiple occasions and the auditor ultimately resigned from the engagement.

Obviously ignoring the qualified advice of legal counsel and auditors is never a wise move. However, this case also highlights more nuanced regulatory friction associated with the original Liquidity Rule. While the Liquidity Rule details the criteria funds should use to classify investments into each of the four liquidity classification buckets, there are subjective elements that funds, their trustees, and advisers should consider carefully when applying those criteria. This case illustrates the risk associated with the fine line between classifying an investment as "less liquid" versus "illiquid". The SEC also **proposed amendments to the Liquidity Rule in November 2022** that, if adopted, would significantly alter those classifying criteria and likely result in many more fund investments being reclassified into lesser liquidity buckets. The amendments remain under consideration.

[1] For purposes of the Liquidity Rule, "illiquid" securities are those that "the fund reasonably expects cannot be sold or disposed of in current market conditions in **seven calendar days or less** without significantly changing the market value of the investment." A "less liquid investment" is one that can be sold or disposed of in seven days "but where the sale or disposition is reasonably expected to settle in more than seven calendar days. Rule 22e4(a)(10).

Affiliate of Firm Facing Liquidity Rule Violations Grapples with its Own Issues

by Andrea Penn

The SEC settled charges against a New York registered investment adviser ("Adviser) for failing to make timely disclosures of conflicts of interest regarding its personnel's ownership of sponsors of special purpose acquisition companies ("SPACs") into which the Adviser recommended its clients invest.

From July 2020 through January 2021, the Adviser's personnel participated in the formation of three SPACs. As a result of their ownership interests in the sponsors of the SPACs, the Adviser's personnel were entitled to receive a portion of the SPAC sponsor compensation. As a result, the Adviser's personnel had material conflicts of interest that could affect the advisory relationship between the Adviser and its advisory clients by giving the Adviser an incentive to render advice that was conflicted. The SEC 's order found that the Advisor repeatedly invested assets of private funds it advised in certain transactions that facilitated the SPACs' business and did not disclose the conflicts of interest in a timely manner. The SEC 's order also found that since at least September 2020, the Adviser failed to adopt and implement written compliance policies and procedures regarding timely disclosures of conflicts of interest relating to the Adviser's personnel's ownership interests in SPAC sponsors and the Adviser's business practice of investing client assets in private placement in public equity ("PIPE") transactions in connection with the business combinations of the affiliated SPACs. Without admitting or denying the findings, the Adviser agreed to a cease-and-desist order, a censure, and a $1 million civil penalty to settle the charges.

SPACs have become increasingly popular in recent years as a way for companies to go public through a merger with a shell company rather than through a traditional initial public offering (IPO). The SEC has a continued heighted awareness regarding advisers with SPAC business practices as there are concerns regarding material misstatements, lack of disclosures, conflicts of interest, inadequate financials, and deficient books and records.

In March 2022, the **SEC proposed rules and amendments** regarding SPACs, shell companies, and projections disclosures. The proposed rules and amendments would require, among other things, enhanced transparency and accountability, additional disclosures about SPAC sponsors, marketing standards, conflicts of interest, and sources of dilution. The proposed rule and amendments would also require additional disclosures regarding business combination transactions between SPACs and private operating companies, including disclosures relating to the fairness of these transactions.

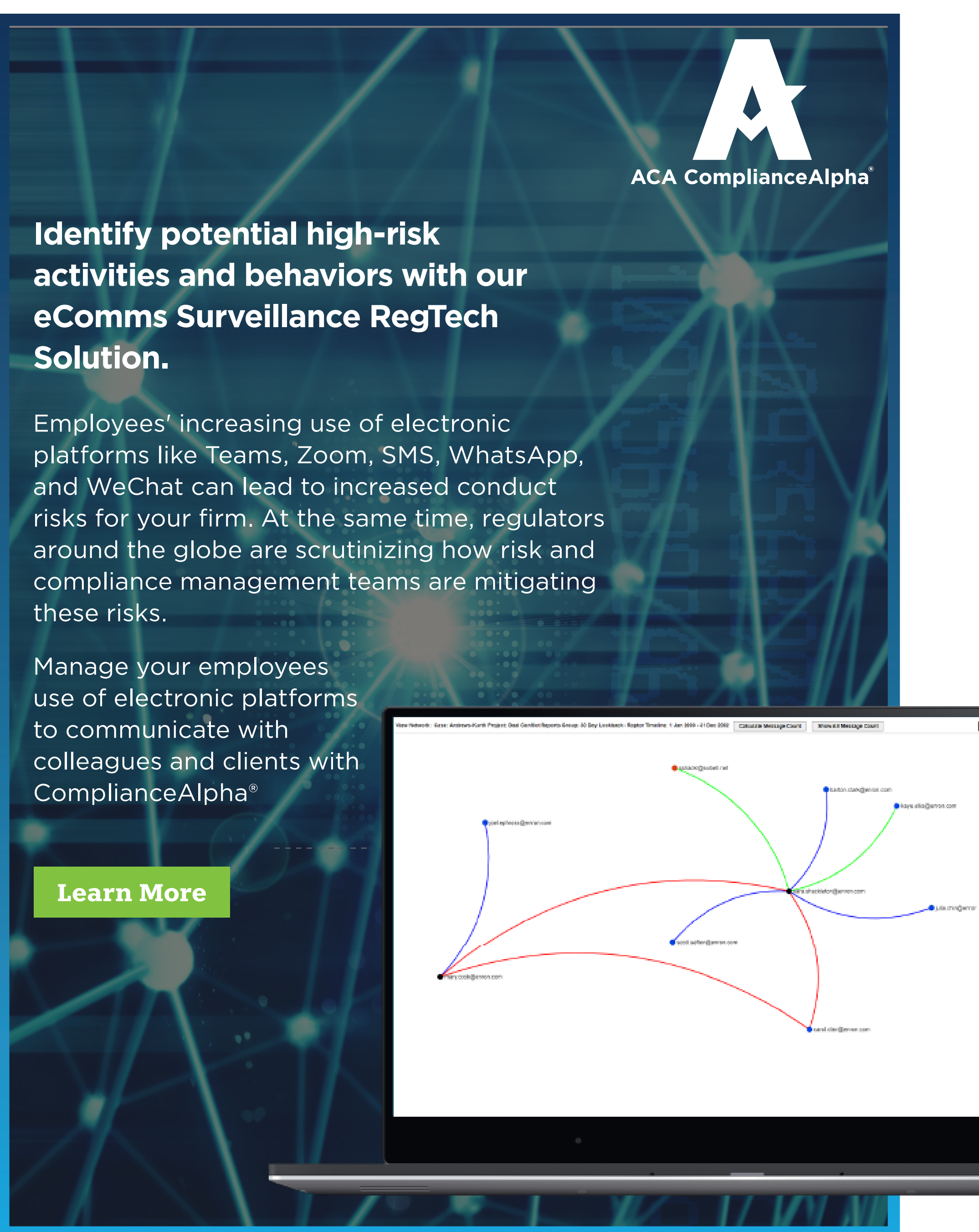
SEC Continues Punishing Firms for E-Comms Recordkeeping Failures

by Jaqueline Hummel

The SEC's e-communications sweep continues with two more cases against broker-dealers for failure to monitor, maintain, and preserve "off channel" electronic communications. The SEC started its **sweep in September 2021** focusing on how firms were monitoring, archiving, and safeguarding employee communications. As a result, the SEC uncovered widespread use of unapproved devices and private messaging apps by employees. In September 2022, the SEC fined **16 firms** for failure to capture certain business communications, as well as failure to supervise their employees by not detecting or preventing the use of unapproved devices. These firms paid fines and penalties in excess of $1.1 billion.

The big twist in these latest cases is that the broker-dealers self-reported the issues and started fixing them back in September 2021. According to the SEC, this self-reporting and self-remediation resulted in reduced penalties. The firms paid $15 million and $7.5 million, respectively. In the earlier cases, including those brought or settled in September 2022, fines ranged from $125 million for larger firms to $50 million for mid-sized firms, although one firm received a $10 million fine.

The message from the SEC is clear – broker-dealers are expected to update their monitoring and recordkeeping of employee communications to capture all the new ways firms communicate with clients. And it seems that the SEC is giving credit to firms that self-report.



Private Fund Manager's Vague Valuation Procedures Leads to SEC Fines

by Vivek Pingili

The SEC sanctioned two related investment advisers (the "Advisers") for allegedly violating Advisers Act Rule 206(4)-7 by lacking sufficient policies and procedures to support the fair valuation of fund assets that did not have a readily available market value (referred to as "Level 3 Investments"). By way of background, the framework for measuring fair value under generally accepted accounting principles (GAAP) is the Financial Accounting Standards Board's (FASB) Accounting Standards Codification Topic 820, Fair Valuation Measurement (ASC 820).

In this case, the Advisers adopted written valuation policies and procedures, however, they simply stated that the firms would value securities without a readily available market value (Level 3 Investments) at fair value, consistent with GAAP ASC 820. The Advisers used vague language that fair value would be "based on available information and several non-exclusive factors which provide the best available estimate of a current market price that [firm] will take into consideration." The Advisers' policies and procedures did not discuss specific valuation techniques or methodologies applicable to Level 3 Investments, which could lead to inconsistent valuation determinations.

> **ACA Observation**: Today it is relatively rare for firms to lack this level of detail in their valuation policies and procedures. This was far more common in the early years after the adoption of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) where even many private equity firms that had robust and consistent valuation practices did not have detailed policies and procedures. This was a cultural phenomenon favoring informal, vague, and open-ended policies and practices. The SEC, however, relatively quickly reshaped this landscape into something that is more granular and formalized.
>
> Granularity, when dealing with the SEC, is a double-edged sword. If a firm's policies are too detailed, SEC examiners can easily find aspects of the valuation policies and procedures that the firm failed to follow, even if they had no material impact on the integrity of the process and the decisions reached. The trick is to strike the right level of detail about the methods in the firm's procedures, supported by robust documentation explaining how the methodologies were applied, and fleshing out grey areas and valuation methodology shifts comprehensively in each instance.
>
> Although many private equity firms include sufficient detail to describe how they arrived at their valuations, they sometimes neglect the "why." For example, an SEC examiner may ask why an adviser chose to value two portfolio companies using two valuation methodologies, discounted cash flow analysis (DCF) and public company comparable analysis. For the first company, the adviser weighted both methodologies at 50%, and for the second company, the adviser weighted the discounted cash flow analysis at 85%and the DCF analysis at 15%. Perhaps the firm determined that there were significant differences between these companies that justified the different weighting. But unless the explanation for the differences in the weighting were included in the documentation, the adviser may be in for an uncomfortable discussion with the examiner. This is a theme the SEC has focused on in the past and we are now seeing a resurgence of that under Gensler.

Returning to this case, the lack of granularity in the valuation policies was further exacerbated by two matters that are also uncommon -- the way management fees were calculated and the Advisers' failure to correct issues raised by their independent public accountants. The Advisers used NAV as the basis for calculating its management fee, while most closed-end private fund advisers calculate management fees based on the amount of investor commitments during the investment period. During the post-investment period, management fees are more commonly stepped down and based either on a lower percentage of investor commitments or an actively invested capital base. By taking this very rare NAV approach, the Advisers were collecting management fees based on unrealized appreciation of fund assets. As a result, any issues with the Advisers' valuations not only posed the risk of the firm creating misleading marketing materials but also charging incorrect or excessive management fees.

In 2016, fund auditors issued a qualified audit opinion for the Advisers' flagship master private equity fund, into which other funds they managed invested. The auditors later withdrew the opinion entirely because they could not obtain sufficient support for the valuation of certain Level 3 assets in the fund. Despite these massive red flags from 2016, the Advisers did not take any action until 2020, when another auditing firm issued restated financial statements for the years 2016 to 2019, writing down its fair valued investment by approximately $32.9 million. The Advisers then made retroactive adjustments in 2020 to the management fees for the funds for the years 2-16 through 2019 to account for the reduction in NAV.

> **ACA Observations:** It's uncommon for private funds to receive qualified opinions, let alone be subject to opinion withdrawals and still fail to take significant corrective action to fix the issues raised. Apart from regulatory scrutiny, sophisticated limited partners and even unsophisticated ones would be all over this. Firms generally do everything they can to avoid a result like this in the first place. Waiting multiple years to address something of such fundamental importance to the fund's limited partners, as alleged by the SEC, is not a common occurrence– if for no other reason than most investors will not allow their private equity firms to get away with such behavior.

Risk Comes from Not Knowing What You Are Doing: Adviser Sanctioned for Using Unsuitable Complex Products

by Andrea Penn

A registered investment adviser and its owner settled charges with the SEC for breach of fiduciary duty of care for investing hundreds of advisory clients in leveraged ETFs. From January 2017 through December 2020, the firm's owner, who was also an investment adviser representative (IAR), purchased leveraged ETFs for advisory client accounts. These leveraged ETFs carried significant risk and were meant to be held for extremely shorts periods of time, such as a single day. Their value tends to decay the longer they are held. The IAR in this case, however, held the leveraged ETFs in client accounts for weeks, months, and even years. Moreover, the IAR's client accounts included a high concentration of leveraged ETFs. The IAR had approximately 290 advisory clients at the time, with 220 clients (76%) in leveraged ETFs.

The SEC found that the IAR misunderstood these fundamental characteristics of the leveraged ETFs and lacked a reasonable belief the leveraged ETFs were in the clients' best interests. The prospectuses for the leveraged ETFs stated that "[l]onger holding periods, higher index volatility and greater leverage each exacerbate the impact of compounding on an investor's returns." In other words, investors holding leveraged ETFs for more than one day risked losing money. The prospectuses also warned that leveraged ETFs required frequent monitoring, which the IAR failed to do. The SEC found that neither the firm nor the IAR understood that the leveraged ETFs were to be used as short-term trading tools and that there were material risks to holding them for periods longer than recommended in the prospectus. Consequently, the firm's and the IAR's use of these securities were not in the clients' best interest.

Further, the firm had no written policies and procedures addressing the material features and risks of leveraged ETFs. Specifically, the firm had not adopted a due diligence process to evaluate the investments, provided product-specific disclosures to clients, or assessed whether leveraged ETFs were suitable for clients. Moreover, the firm provided no training for IARS on leveraged ETFs and had not adopted procedures for supervisory review and monitoring of leveraged ETFs. Without admitting or denying the findings, the firm and the IAR agreed to a cease-and-desist order, censures, and paid more than $900,000 to the SEC to settle the allegations.

This enforcement action serves as an important reminder that leveraged ETFs present significant risks for retail clients. Investment advisers should understand the risks regarding leveraged ETFs to ensure that their recommendations are suitable and in the client's best interest. Investment advisers should consider adopting reasonable policies and provide adequate training regarding leveraged ETFs.

Worth Reading, Listening and Watching

- FINRA is sponsoring this free webinar: **Senior Safe Act Webinar: Identifying and Reporting Suspected Exploitation.**
- **Florida Enacts Anti-ESG Legislation – House Bill 3 explained**. In a show of continued division along political lines, there is a small but growing number of states enacting "anti-ESG" legislation. Florida is the latest. This was also a topic of discussion on the panels at the recent SEC Emerging Issues in Asset Management event. See below for details on this inaugural event.
- **2023 Senior Investor Protection Conference: The Latest Trends, Scams and Schemes**. On this podcast episode, FINRA takes an abridged look at one of the sessions from its recent 2023 Senior Investor Protection Conference on the various trends, scams, and schemes currently impacting investors.
- **SEC Adopts New Share Repurchase Disclosure Requirements** – Skadden breaks down the new share repurchase disclosure requirements that apply to domestic issuers, foreign private issuers, and listed closed-end funds.
- **SEC - Emerging Issues in Asset Management**. In a first-of-its-kind event, the SEC gathered an impressive group of panelists from across the industry to exchange ideas on a wide variety of important issues facing the financial services industry. The day-long event was open to the public via live attendance and webcast. A copy of the recording is not yet available at the time of this newsletter but check back periodically: **https://www.sec.gov/news/sec-webcasts**.

Recent ACA thought leadership:

Below are select ACA articles over the past month we think are worth reading. Find all updates on the **Insights** section of our website.

Recent and Upcoming Webcasts:

- **Launching an ETF: A Playbook to Success**
- **Privacy Update: The CPRA and the Evolving U.S. Privacy Landscape**

Tips for Updating Your Compliance Program:

- **Shareholder Reporting Requirements and Amendments to Advertising Rules**
- **Enhanced Proxy Voting Requirements**
- **SEC Exam Observations Risk Alert**

To Do Checklists for the Months of June / July 2023

Investment Advisers

June / July

- [ ] **GIPS Notification Requirement**: Firms opting to comply with the Global Investment Performance Standards (GIPS) must notify the CFA Institute of its claim of compliance on an annual basis. This notification is due **June 30, 2023**, and should be submitted by completing the appropriate **online form** on the CFA Institute's website.

- [ ] **Form 13H:** Following an initial filing of Form 13H, all large traders must make an amended filing to correct inaccurate information promptly (within ten days) following the quarter-end in which the information became stale. **Recommended due date: July 10, 2023.** *(Note: Neither the SEC nor its staff has provided guidance on the definition of "promptly" for Form 13H.)*

Hedge / Private Fund Advisers

June / July

- [ ] **Blue Sky Filings (Form D):** Advisers to private funds should review fund blue sky filings and determine whether any amended or new filings are necessary. Generally, most states require a notice filing ("blue sky filing") within 15 days of the first sale of interests in a fund, but state laws vary. Did you know ACA offers a convenient and economical blue sky filing service to help firms manage this complicated monthly task? Give us a call to discuss your needs further.
  Due June 15, 2023

- [ ] **Distribute Audited Financial Statements for Private Funds for Funds of Funds:** Private fund investment advisers should have their funds audited by an independent, PCAOB-registered accountant and deliver the audited financial statements to the funds' investors within 120 days of the end of the funds' fiscal year. The deadline for private funds that are fund of funds is 180 days of the funds' fiscal year-end. That's **June 29, 2023,** for funds with **December 31 year-end.**

- [ ] **Form PF for Large Fund Advisers:** Large hedge fund advisers must file Form PF within 60 days of each quarter-end on the IARD system.
  Due July 15, 2023.

- [ ] **Blue Sky Filings (Form D):** Advisers to private funds should review fund blue sky filings and determine whether any amended or new filings are necessary. Generally, most states require a notice filing ("blue sky filing") within 15 days of the first sale of interests in a fund, but state laws vary. Did you know Foreside offers a convenient and economical blue sky filing service to help firms manage this complicated monthly task? Give us a call to discuss your needs further.
  Due July 15, 2023.

Registered Commodity Pool Operations

June /July

- [ ] **Form CPO-PQR:** Small, mid-sized, and large commodity pool operators are required to file NFA Form CPO-PQR quarterly with the NFA.
Due May 30, 2023

Broker-Dealers

June / July

- [ ] **Supplemental Liquidity Schedule (SLS)**: For the month ending April 30, 2023. The SLS must be filed by each carrying member with $25 million or more in free credit balances, and by each member whose aggregate amount outstanding under repurchase agreements, securities loan contracts and bank loans is equal to or greater than $1 billion, as reported on the member's most recently filed FOCUS Report, unless otherwise permitted by FINRA in writing. The SLS must be completed as of the last business day of each month and filed within 24 business days after the end of the month. A member need not file the SLS for any period where the member does not meet the $25 million or $1 billion thresholds.
Due June 2, 2023

- [ ] **Rule 17a-5 Monthly and Fifth FOCUS Part II/IIA Filings**: For the period ending May 31. For firms required to submit monthly FOCUS filings and those firms whose fiscal year-end is a date other than a calendar quarter.
Due June 24, 2023

- [ ] **Supplemental Inventory Schedule (SIS)**: For the month ending May 31. The SIS must be filed by a firm that is required to file FOCUS Report Part II, FOCUS Report Part IIA or FOGS Report Part I, with inventory positions as of the end of the reporting period, unless the firm has (1) a minimum dollar net capital or liquid capital requirement of less than $100,000; or (2) inventory positions consisting only of money market mutual funds. A firm with inventory positions consisting only of money market mutual funds must affirmatively indicate through the eFOCUS system that no SIS filing is required for the reporting period.
Due June 29, 2023

- [ ] **Annual Reports for Fiscal Year-End April 30**: FINRA requires that member firms submit their annual reports in electronic form. Firms must also file the report at the regional office of the SEC in which the firm has its principal place of business and the SEC's principal office in Washington, DC. Firms registered in Arizona, Hawaii, Louisiana, or New Hampshire may have additional filing requirements.
Due June 29, 2023 (Conditional 30-Day Extension may be available.)

- [ ] **SIPC-7 Assessment**: For firms with a Fiscal Year-End of April 30th. SIPC members are required to file the SIPC-7 General Assessment Reconciliation Form, together with the assessment owed (less any assessment paid with the SIPC-6) within 60 days after the Fiscal Year-End.
Due June 29, 2023

- [ ] **SIPC-3 Certification of Exclusion from Membership**: For firms with a Fiscal Year-End of May 31 AND claiming an exclusion from SIPC Membership under Section 78ccc(a)(2)(A) of the Securities Investor Protection Act of 1970. This annual filing is due within 30 days of the beginning of each fiscal year.
Due June 30, 2023

Broker/Deakers (continued)

- [ ] **SIPC-6 Assessment**: For firms with a Fiscal Year-End of November 30th. SIPC members are required to file for the first half of the fiscal year a SIPC-6 General Assessment Payment Form together with the assessment owed within 30 days after the period covered.
Due June 30, 2023

- [ ] FINRA Accounting Support Fee: Quarterly invoice to support the GASB budget. Based on the municipal securities the firm reported to the MSRB. De Minimis firms (that owe less than $25) will not receive an invoice. Invoices are sent to the firm via WebCRD's E-Bill.
Due date TBD

- [ ] **Supplemental Liquidity Schedule (SLS)**: For the month ending May 31, 2023. The SLS must be filed by each carrying member with $25 million or more in free credit balances, and by each member whose aggregate amount outstanding under repurchase agreements, securities loan contracts and bank loans is equal to or greater than $1 billion, as reported on the member's most recently filed FOCUS Report, unless otherwise permitted by FINRA in writing. The SLS must be completed as of the last business day of each month and filed within 24 business days after the end of the month. A member need not file the SLS for any period where the member does not meet the $25 million or $1 billion thresholds.
Due July 6, 2023

- [ ] **Customer Complaint Quarterly Statistical Summary**: For complaints received during the second quarter. FINRA Rule 4530 requires Firms to submit statistical and summary information regarding complaints received during the quarter by the 15th day of the month following the calendar quarter.
Due July 15, 2023

- [ ] **Quarterly FOCUS Part II/IIA Filings**: For Quarter ending June 30. FINRA requires that member firms file a FOCUS (Financial and Operational Combined Uniform Single) Report Part II or IIA quarterly. Clearing firms and firms that carry customer accounts file Part II and introducing firms file Part IIA.
Due July 26, 2023

- [ ] **Quarterly Form Custody**: SEC requires that member firms file Form Custody under Securities Exchange Act Rule 17a-5(a)(5) for the quarter ending June 30.
Due July 26, 2023

- [ ] **Supplemental Statement of Income (SSOI)**: For the quarter ending June 30. FINRA requires firms to submit additional, detailed information regarding the categories of revenues and expenses reported on the Statement of Income (Loss) page of the FOCUS Report Part II/IIA.
Due July 31, 2023

- [ ] **Supplemental Inventory Schedule (SIS)**: For the month ending June 30. The SIS must be filed by a firm that is required to file FOCUS Report Part II, FOCUS Report Part IIA or FOGS Report Part I, with inventory positions as of the end of the FOCUS or FOGS reporting period, unless the firm has (1) a minimum dollar net capital or liquid capital requirement of less than $100,000; or (2) inventory positions consisting only of money market mutual funds. A firm with inventory positions consisting only of money market mutual funds must affirmatively indicate through the eFOCUS system that no SIS filing is required for the reporting period.
Due July 31, 2023

- [ ] **SIPC-3 Certification of Exclusion from Membership**: For firms with a Fiscal Year-End of June 30 AND claiming an exclusion from SIPC Membership under Section 78ccc(a)(2)(A) of the Securities Investor Protection Act of 1970. This annual filing is due within 30 days of the beginning of each fiscal year.
Due July 31, 2023

- [ ] **SIPC-6 Assessment**: For firms with a Fiscal Year-End of December 31. SIPC members are required to file for the first half of the fiscal year a SIPC-6 General Assessment Payment Form together with the assessment owed within 30 days after the period covered.
  Due July 31, 2023.

- [ ] **SIPC-7 Assessment**: For firms with a Fiscal Year-End of May 31. SIPC members are required to file the SIPC-7 General Assessment Reconciliation Form, together with the assessment owed (less any assessment paid with the SIPC-6) within 60 days after the Fiscal Year-End.
  Due July 31, 2023.

Mutual Funds

June / July

- [ ] **Form N-MFP:** Form N-MFP (Monthly Schedule of Portfolio Holdings of Money Market Funds) reports information about the fund's holdings as of the last business day of the prior calendar month and must be filed no later than the fifth business day of each calendar month.
  Due June 7, 2023

- [ ] **Form N-MFP:** Form N-MFP (Monthly Schedule of Portfolio Holdings of Money Market Funds) reports information about the fund's holdings as of the last business day of the prior calendar month and must be filed no later than the fifth business day of each calendar month.
  Due July, 10, 2023.

About ACA

ACA Group (ACA) is the leading governance, risk, and compliance (GRC) advisor in financial services. For over 20 years, we've empowered our clients to reimagine GRC to protect and grow their business. Our global team includes former regulators and practitioners with a deep understanding of the regulatory landscape. Our innovative approach integrates advisory, managed services, distribution solutions, and analytics with our ComplianceAlpha® technology platform.

For more information, visit
www.acaglobal.com

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About the Authors

Cari A. Hopfensperger

Cari A. Hopfensperger is a Director for ACA's US Regulatory Advisory Group. She has an extensive background in regulatory compliance and provides compliance consulting services to retail and institutional focused registered investment advisers, including private and registered fund managers. She works with clients to develop effective compliance programs and solve complex regulatory issues, including serving as an Outsourced CCO.

Prior to joining ACA, Cari was a managing director at Hardin Compliance Consulting, LLC, which was purchased by Foreside in June 2021. Before that, she served in various compliance and operational leadership roles for a Chicago-based registered investment adviser, including Chief Compliance Officer, head of fund services and operations. Previously, Cari managed operations and client service for a Chicago-area boutique registered investment adviser.

Cari received a B.A. in English from the University of Wisconsin-Madison and a master of business administration from Keller Graduate School of Management. She is a member of the National Society of Compliance Professionals (NSCP) and currently serves as co-chair of the NSCP Publications Committee and chair of its professional development subcommittee.

Jaqueline M. Hummel

Jaqueline M. Hummel is Director Director of Thought Leadership, Regulatory Compliance. She is a securities attorney and regulatory compliance consultant with extensive experience as an in-house attorney working in the areas of investment adviser, broker-dealer, and investment company regulation and compliance. Ms. Hummel provides compliance consulting services to registered investment advisors, working to develop effective compliance programs and solve complex regulatory issues, including serving as an Outsourced CCO.

Before joining ACA, she served as a partner at Hardin Compliance Consulting LLC, which was purchased by Foreside in June 2021. Before that, Ms. Hummel held the position of Chief Compliance Officer for PNC Capital Advisors and PNC Realty Investors, investment adviser affiliates of PNC Financial Services Group, Inc. She also served as in-house counsel for National City Corporation's investment adviser and broker-dealer affiliates where her responsibilities included being the Chief Compliance Officer for Allegiant Asset Management Company. Prior to joining National City, Ms. Hummel served many years as in-house counsel for MassMutual Financial Group, a diversified financial services organization, where she advised the investment management division, including affiliated registered investment advisers and registered investment companies.

Ms. Hummel holds the designation of Investment Adviser Certified Compliance Professional (IACCP®) from National Regulatory Services, Inc. She received a B.A. from the University of Wisconsin-Madison and a J.D. from Emory University School of Law.

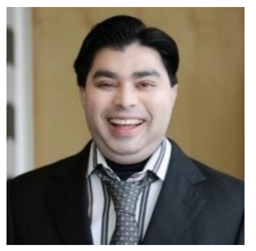
About the Authors

Andrea Penn

Andrea Penn is a Senior Principal Consultant with ACA Group where she provides regulatory advice and guidance to registered investment advisors. She also serves as an outsourced CCO. Andrea has extensive broker-dealer sales practice and supervision compliance experience relating to Global Wealth and Investment Management.

Previously, Andrea was a Vice President at Merrill Lynch and Associate Manager at UBS in both their corporate compliance departments in the New York metro region. She is also a former regulator with FINRA in New York (District 10) and conducted examinations of member firms' sales practice and supervisory compliance programs.

Andrea has a Bachelor of Arts from the University of Delaware.



Vivek Pingili

Vivek Pingili is a Director of ACA's Private Funds Practice and focuses on corporate governance, operational and regulatory compliance matters relating to private markets investment managers. As a private markets specialist, Vivek helps a broad range of domestic and international private markets investment managers (including venture capital, private equity, private real estate, private credit, and private equity fund-of-funds managers) successfully implement and maintain comprehensive regulatory and operational compliance programs (including joint FCA and SEC compliance programs). Vivek also helps clients prepare for SEC audits.

Prior to joining ACA, Vivek was senior counsel in the Private Investment Funds practice group at Proskauer Rose LLP. While at Proskauer, Vivek represented a broad range of illiquid asset managers, including managers of buy-out funds, secondary funds, venture capital funds, private real estate funds and fund-of-funds, in regulatory compliance matters as well as in connection with the structuring, formation, offering and ongoing operations of such funds.

Vivek received a J.D. from Northeastern University School of Law and a B.A., magna cum laude, from Brandeis University.