Investment Management Update

November 2024

In This Update

Covering legal developments and regulatory news for funds, their advisers, and industry participants for the quarter ended September 30.

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Rulemaking and Guidance

SEC Adopts Reporting Enhancements for Registered Investment Companies and Provides Guidance on Open-End Fund Liquidity Risk Management Programs

08.28.24

On August 28, the U.S. Securities and Exchange Commission (SEC) adopted amendments to certain registered investment companies (funds) reporting requirements. The SEC originally proposed the amendments on November 2, 2022.

Goals of the Amendments

The amendments aim to improve the SEC's oversight of the asset management industry and enhance public transparency by:

- Requiring more timely reporting of funds' monthly portfolio holdings and related information to the SEC, which will benefit fund investors by promoting more effective regulatory monitoring and oversight of the fund industry;
- Providing for more frequent public disclosure of funds' portfolio holdings to assist investors with making better, informed investment decisions; and
- Requiring information about service providers that open-end funds use to comply with liquidity risk management program requirements, which will allow tracking of certain liquidity risk management practices.

Additionally, in connection with the amendments, the SEC also provided guidance related to open-end fund liquidity risk management program requirements.

Overview of the Need for the Amendments

The SEC is the primary regulator of the asset management industry. Accordingly, the SEC leverages information filed in reports of registered investment companies for various purposes, including monitoring industry trends, identifying risks, informing policy and rulemaking, and assisting the SEC staff in examination and enforcement efforts. Currently, registered management investment companies (besides money market funds and small business investment companies) and exchange-traded funds organized as unit investment trusts are required to file periodic reports on Form N-PORT about their portfolio holdings as of month-end. Funds must maintain accurate records of this monthly information within 30 days of month-end, but they are not required to file the information with the SEC until 60 days after the end of a quarter.

The SEC adopted this filing frequency in an interim final rule in 2019 in connection with its assessment of its internal cybersecurity risk profile. Since 2019, market events have reinforced the need for more timely data to facilitate the SEC's ability to develop a more current, comprehensive understanding of the market and then appropriately respond to market stresses as they develop.

Further, investors benefit from increased access to information from these reports about a given fund's portfolio holdings to make more informed investment decisions. For example, portfolio holding information can help investors assess how their different funds have portfolios that overlap along with how funds comply or deviate from their investment goals. Investors may also benefit from a third-party analysis of the information, such as analysis by data aggregators, broker-dealers, investment advisers, and others that provide investment information to fund investors and assist investors in selecting fund investments.

Currently, the public has access to Form N-PORT information for only the third month of each quarter. Consequently, the SEC hopes that this increased frequency and timeliness of Form N-PORT reports enhance the SEC's oversight of the asset management industry. Similarly, the increased publication frequency of the reports should improve public transparency for the benefit of funds investors.

Application of the Amendments

- Form N-PORT Filing and Publication Frequency

The Form N-PORT amendments will require funds to file Form N-PORT reports more frequently and timely. Specifically, these reports will be filed monthly and within 30 days after the end of each month. The amendments will also increase the publication frequency of funds' monthly reports, so that each monthly report will need to be public 60 days after the end of the month. Additionally, funds will no longer be required to maintain records of this monthly information within 30 days of month-end because the information will now be filed with the SEC.

- Form N-CEN Liquidity Service Provider Information

The Form N-CEN amendments will require open-end funds that are subject to the Rule 22e-4 liquidity risk management program requirements under the Investment Company Act of 1940 (Liquidity Rule) to report certain information about the service providers used to fulfill those requirements. For example, funds may have to report identifying information about the liquidity service providers and the asset classes for which the liquidity service providers are used.

- Guidance on Certain Open-End Fund Liquidity Risk Management Program Requirements

The Liquidity Rule guidance also addresses questions raised through outreach and monitoring, specifically relating to:

  - The frequency of classifying the liquidity of fund investments;
  - The meaning of "cash" in the Liquidity Rule; and
  - Determining and reviewing highly liquid investment minimums.

Next Steps in Implementation of the Amendments

The amendments will become effective on November 17, 2025. Most funds will need to comply with these amendments for reports filed on or after this effective date. Funds with net assets of less than $1 billion, however, will have until May 18, 2026, to comply with the Form N-PORT amendments.

A copy of the final rule amendments can be found at: https://www.sec.gov/files/rules/final/2024/ic-35308.pdf.

Litigation and Enforcement

SEC Charges Registered Adviser for Compliance Failures in Handling of Nonpublic Information

08.26.24

The SEC has taken action against Sound Point Capital Management, LP, a registered investment adviser, for not having proper policies to prevent the misuse of confidential information in their trading activities.

From May 2018 to June 2024, Sound Point did not have written policies to stop the misuse of material nonpublic information (MNPI) related to their trading of collateralized loan obligations (CLOs). In July 2019, Sound Point sold CLO equity tranches while possessing confidential information about a media services company, known as Company A. When this information became public on July 31, 2019, the value of Company A's loans dropped by more than 50%, significantly decreasing the value of the CLO tranches Sound Point had sold the previous day by about $685,000. Despite some employees recognizing they had MNPI, Sound Point did not consider its impact on the CLO tranches before selling them.

Before July 2022, Sound Point did not have written policies to prevent the misuse of MNPI in their CLO trading. Although they started conducting pre-clearance reviews in July 2019 to assess the impact of MNPI on their trading, these procedures were not formalized until July 2022. Additionally, Sound Point did not have any policies to prevent the misuse of MNPI in third party CLOs during the relevant period, even though they were actively trading these CLOs.

Due to these shortcomings, Sound Point violated Sections 204A and 206(4) of the Investment Advisers Act and Rule 206(4)-7 thereunder. These sections require investment advisers to have written policies to prevent the misuse of MNPI and to adopt procedures to prevent violations of the Advisers Act. The SEC has ordered Sound Point to stop further violations, censured the firm, and imposed a $1.8 million civil penalty. This order highlights the need for investment advisers to have strong compliance policies to prevent the misuse of confidential information.

The SEC considered the remedial actions taken by Sound Point and their cooperation with the investigation. After the incident with Company A, Sound Point began conducting compliance reviews before trading their CLOs, considering the loan exposure and potential MNPI. However, it was not until April 2024, due to the SEC's investigation, that Sound Point started conducting pre-clearance reviews for Third Party CLOs and adopted written policies for these reviews in June 2024.

This case underscores the importance of having comprehensive and enforced policies to prevent the misuse of sensitive information in investment advisory practices. The SEC's order emphasizes that investment advisers must establish and maintain effective compliance programs to protect the integrity of the financial markets.

For a copy of the SEC’s Administrative Order, click here: https://www.sec.gov/files/litigation/admin/2024/ia-6666.pdf.

SEC Charges Registered Adviser With Custody Rule and Liability Disclaimer Violations

09.03.24

On September 3, the SEC entered a cease-and-desist order and imposed remedial sanctions against ClearPath Capital Partners, LLC (ClearPath). ClearPath is a registered investment adviser that advises retail investors and private funds. The charges stem from ClearPath's violations of the federal securities laws in connection with its financial statement audits of private funds that ClearPath advised and its use of liability disclaimer language, known in the industry as a hedge clause, in its advisory agreements and in private fund partnership and operating agreements.

ClearPath was a general partner of ClearPath Special Opportunities Fund 2017, LP, which invested in select technology companies through other unaffiliated private investment vehicles, until the fund was liquidated in 2019. ClearPath is currently the manager of ClearPath Opportunities Fund, LLC, which was formed in 2021, and invests in emerging companies through other unaffiliated private investment vehicles. ClearPath Special Opportunities Fund 2017, LP and ClearPath Opportunities Fund, LLC are collectively the "Funds."

ClearPath Failed to Timely Distribute Required Audited Financial Statements

The SEC concluded that ClearPath violated Section 206(4) of the Investment Advisers Act of 1940 (Advisers Act), and Rule 206(4)-2 thereunder, which is often referred to as the "Custody Rule". The Custody Rule requires that registered investment advisers that have custody of client funds or securities implement an enumerated set of requirements to prevent the loss, misuse, or misappropriation of those assets. The SEC determined that ClearPath had custody of the Funds' respective assets. An investment adviser can comply with its responsibilities under the Custody Rule if it distributes the particular fund's audited financial statements prepared in accordance with GAAP to all limited partners within 120 days of the end of the fund's fiscal year.

According to the SEC, from roughly 2018 through 2022, ClearPath did not comply with the Custody Rule by failing seven different times to timely distribute to the Funds' investors annual audited financial statements prepared in accordance with GAAP. The financial statements for the Funds that were ultimately delivered to investors were 333 to 1,064 days after the Funds' relevant fiscal year end.

ClearPath's Improper Limitation of Liability in Advisory Agreements and Private Fund Agreements

The Advisers Act establishes a federal fiduciary duty for investment advisers and this duty may not be waived, though its application may be shaped by agreement. Additionally, under the Advisers Act, advisory agreements may not misrepresent, or contain misleading statements regarding the scope of an adviser's unwaivable fiduciary duty that could lead a client to incorrectly believe that the client has waived a nonwaivable cause of action against the adviser provided by state or federal law. Language intending to limit an adviser's liability in an advisory agreement is called a "hedge clause."

From at least 2019, ClearPath's advisory agreements and certain private fund partnership and operating agreements used improper hedge clauses because they purported to broadly limit ClearPath's liability, specifically its fiduciary duties. The SEC deemed that the hedge clauses contained misleading statements regarding the scope of ClearPath's unwaivable fiduciary duty, which could lead clients to incorrectly believe that they waived a nonwaivable cause of action against ClearPath.

Violations

As a result of the conduct described above, the SEC found that ClearPath's failure to timely distribute required audited financial statements willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-2 thereunder. The SEC also found that ClearPath's use of hedge clauses willfully violated Section 206(2) of the Advisers Act, which makes it unlawful "to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client."

Further, the SEC found that ClearPath willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-7 promulgated thereunder, which require, among other things, that an investment adviser: (a) adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and its rules; and (b) review at least annually its written policies and procedures and the effectiveness of their implementation.

Remedial Steps

After the SEC considered ClearPath's various remedial actions, including revising its procedures for complying with the Custody Rule and the removal of the hedge clauses from its advisory and private fund agreements, the SEC and ClearPath agreed to a settlement offer. The parties agreed in the settlement offer that (1) ClearPath cease and desist from committing or causing any violations and any future violations of Section 206(2) of the Advisers Act, Section 206(4)(2) of the Advisers Act and Rule 206(4)-2 thereunder, and Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder; (2) ClearPath is censured; and (3) ClearPath shall, within 10 days of the entry of the settlement order pay a civil money penalty of $65,000 to the SEC.

For a copy of the SEC's Administrative Order, click here: https://www.sec.gov/files/litigation/admin/2024/ia-6672.pdf.

SEC Charges Registered Advisory Firm With Cross-Trading Violations

09.19.24

Macquarie Investment Management Business Trust (MIMBT) has agreed to pay $79.8 million to settle charges brought by the SEC for overvaluing collateralized mortgage obligations (CMOs) when pricing certain cross-trades among affiliates, including registered investment companies that resulted in, among others, infractions of Section 206 of the Investment Advisers Act of 1940 (Advisers Act) and Section 17(a) of the Investment Company Act of 1940 (1940 Act).

The SEC found that MIMBT had overvalued approximately 4,900 largely illiquid CMOs held in 20 advisory accounts, including 11 retail mutual funds by using round lot prices for odd lot positions. The firm used the higher round lot prices for cross trades between advisory clients that benefited the sellers at the expense of the buyers in the cross-trades.

From January 2017 to April 2021, MIMBT managed the Absolute Return Mortgage-Backed Securities strategy, which focused on fixed-income investments primarily in mortgage-backed securities, agency CMOs, and treasury futures. This strategy included thousands of smaller "odd lot" CMO positions, which often trade at a discount compared to larger positions. MIMBT used prices from a third-party pricing service to value these odd lot CMOs, even though the service only provided valuations for institutional-sized lots. The third-party vendor did not provide separate valuations for odd lot positions. As a result, the SEC concluded that MIMBT had no reasonable basis to believe it could sell the odd lot CMOs at the vendor's institutional-sized lot valuations, leading to thousands of these odd lot positions being marked at inflated prices.

The SEC found that MIMBT, on behalf of certain of its nonmutual fund clients, sold securities to affiliated mutual funds through these cross trades using prices higher than those that could be obtained in the market. For instance, MIMBT carried out 465 internal cross trades between a selling account and 11 retail mutual funds at prices higher than the independent current market rates.

Moreover, MIMBT arranged around 175 dealer-interposed cross trades. This involved temporarily selling odd lot CMO positions to broker-dealers and then repurchasing them for affiliated clients. By organizing these internal and dealer-interposed trades, the order finds that these transactions were frequently executed at prices above the market rate, thus deviating from current market prices and providing liquidity in an otherwise illiquid market. As a result, the SEC found that MIMBT violated the antifraud and compliance provisions of the Advisers Act and the rules thereunder, and the prohibitions against affiliated transactions, anti-fraud and compliance provisions of the Investment Company Act of 1940, and the rules thereunder. In particular, the cross-trades with the affiliated mutual funds violated the prohibition on affiliated principal transactions in Section 17(a) of the 1940 Act because they failed to meet the conditions of Rule 17a-7 (conditionally permitting certain affiliated cross-trades) because the cross-trades were not priced as required by the rule (*i.e.*, did not use current market prices).

The SEC settlement concludes a probe related to MIMBT's absolute return mortgage-backed securities strategy, which the firm discontinued in April 2021. While MIMBT did not admit or deny the charges, it has agreed to pay a civil penalty of $70 million and $9.8 million in disgorgement and prejudgment interest.

As part of the settlement, MIMBT will also adhere to certain undertakings, including appointing a compliance consultant to conduct a comprehensive review of its policies and procedures related to cross trading valuation, CMOs valuation, and associated liquidity risk, the SEC noted.

For a copy of the SEC's Administrative Order, click here: https://www.sec.gov/files/litigation/admin/2024/ia-6709.pdf.

Advisory Firm Charged With Recordkeeping Violations, Avoids Civil Penalty Because of Self-Reporting, Substantial Cooperation, and Prompt Remediation

09.23.24

The SEC has charged Texas-based registered investment adviser Atom Investors LP for failing to maintain and preserve off-channel communications, violating federal securities laws' recordkeeping provisions. Despite these violations, Atom Investors avoided a penalty by self-reporting the misconduct, promptly addressing the issues, and cooperating substantially in an investigation involving another entity.

According to the SEC's order, in 2021, the SEC issued a subpoena to Atom Investors for documents related to an investigation of a third party. During its response, Atom Investors discovered it had failed to preserve required records, including those responsive to the SEC's subpoena. These records included communications by senior personnel related to securities transaction recommendations and advice.

The issue became clear when Atom Investors acknowledged that required communications were missing or incomplete over a period exceeding three years, significantly hindering the SEC's investigation.

Atom Investors' failure to preserve required communications violated the recordkeeping rules under Section 204(a) of the Investment Advisers Act of 1940 and Rule 204-2 thereunder. These rules require investment advisers to keep certain business records and provide copies when requested. By failing to save off-channel communications, Atom Investors further failed to meet its recordkeeping duties.

Atom Investors' self-reporting and prompt remedial actions were key factors in the Enforcement Division's recommendation not to impose a penalty, which the SEC accepted.

This resolution should serve as a model for other investment advisers who are not currently in compliance with federal recordkeeping requirements."

For a copy of the SEC's Administrative Order, click here:
https://www.sec.gov/files/litigation/admin/2024/ia-6719.pdf.

SEC Charges Advisory Firm With Violating Whistleblower Protection Rule

09.26.24

The SEC instituted administrative and cease-and-desist proceedings against GQG Partners LLC for violations of whistleblower protections under Exchange Act Rule 21F-17(a). The SEC found that from November 2020 through September 2023, GQG required potential employees to sign nondisclosure agreements (NDAs) that impeded their ability to report potential securities law violations to the SEC. These NDAs prohibited disclosure of confidential information to government agencies and required notification to GQG if such a request was made, violating Rule 21F-17(a).

Additionally, GQG entered into a settlement agreement with a former employee who intended to report potential securities law violations to the SEC. The agreement included provisions that required the former employee to represent that they had not initiated any investigation and were aware of no facts that would form the basis of such an investigation, which also violated Rule 21F-17(a).

GQG is a Delaware limited liability company registered with the SEC as an investment adviser, with approximately $120.6 billion in regulatory assets under management and 189 employees as of March 2024.

The SEC's order includes the following key points:

1. GQG's NDAs and settlement agreement violated Rule 21F-17(a) by impeding individuals from communicating directly with the SEC about possible securities law violations.

2. GQG has taken remedial actions, including stopping the use of the violative NDA template, revising the template to include a carve-out for whistleblowing, and notifying affected individuals that the NDAs and settlement agreement do not prohibit them from communicating with the SEC.

3. The SEC has ordered GQG to cease and desist from future violations, censured the company, and imposed a civil money penalty of $500,000.

The order emphasizes the importance of protecting whistleblowers and ensuring that individuals can report potential securities law violations without fear of retaliation or impediment.

For a copy of the SEC’s Administrative Order, click here: https://www.sec.gov/files/litigation/admin/2024/34-101200.pdf.

SEC and SRO News

Keith E. Cassidy Named Interim Acting Director of the Division of Examinations

07.22.24

On July 22, the SEC announced that Director of the Division of Examinations Richard Best would be taking a leave of absence to address a medical issue. During his absence, Keith E. Cassidy, who currently serves as the Division's Deputy Director, will step in as the interim Acting Director.

Cassidy brings a wealth of experience to his interim role. In addition to his responsibilities as Deputy Director, he serves as the National Associate Director of the Division's Technology Controls Program. In this capacity, he is responsible for overseeing technology-focused examinations and managing the SEC's CyberWatch program and the Cybersecurity Program Office. His extensive background in technology and cybersecurity makes him well-suited to lead the Division during this transitional period.

Cassidy's career also includes significant experience in legislative and intergovernmental affairs. He previously served as the Director of the SEC's Office of Legislative and Intergovernmental Affairs, where he was responsible for managing the agency's interactions with Congress and other government entities. Additionally, he has held the role of Chief of Staff and Counsel at the Department of Justice's Office of Legislative Affairs, further showcasing his expertise in navigating complex regulatory environments.

Richard R. Best Named Senior Advisor to the Director of the Division of Examinations

09.27.24

The SEC announced that Richard R. Best, the Director of the Division of Examinations, will transition to a senior advisor role to the Director of the Division of Examinations after his medical leave. Keith E. Cassidy, who has held the role of Acting Director since July, will continue in this role.

As Director, Best led the National Examination Program, overseeing more than 1,000 professionals across 10 regional offices and headquarters. He emphasized the Division's mission to prevent fraud, promote compliance, monitor risk, and inform policy, enhancing transparency and communication with investors and the industry.

Before his role as Director of the Division of Examinations, Best served as the Director of the SEC's New York, Atlanta, and Salt Lake Regional Offices. His career also includes supervisory, litigation, and investigative roles at the Financial Industry Regulatory Authority and a decade as a prosecutor in the Bronx County District Attorney's Office.

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