Simpson Thacher

Registered Funds Regulatory Update

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SEC Staff Guidance

SEC Issues FAQs Related to Final Rule on Tailored Shareholder Reports

The Staff of the SEC's Division of Investment Management issued a series of FAQs related to the SEC's adoption of the October 2022 final rule and form amendments on tailored investment reports that require mutual funds and ETFs to transmit concise and visually engaging annual and semi-annual shareholder reports under the Investment Company Act and promote transparent and balanced presentations of fees and expenses in investment company advertisements. This latest update provides guidance in anticipation of the approaching compliance deadline on July 24, 2024.

The following is an overview of the FAQs:

Appropriate Broad-Based Securities Market Index

The final rules require a fund to show its performance against an "appropriate broad-based securities market index," which is defined as "the overall applicable domestic or international equity or debt markets, as appropriate." The adopting release stated that a fund must select an index that "reasonably represents" the applicable market and included some examples. The FAQ provided that:

- An index that pertains to the equity or fixed income market of a group of countries, a group of countries excluding a specific country or countries, or a group of countries with shared characteristics such as emerging markets or developed markets could qualify as an appropriate broad-based securities market index, provided that the index represents the overall applicable international equity or debt market relative to the fund's investments.
- An index representing the national municipal securities market—as opposed to an index for the national aggregate fixed income securities market—could qualify as a broad-based securities market index for a tax-exempt municipal securities fund, including a fund that invests primarily in the municipal securities of a single state.

Form N-CSR and Website Availability Requirements

Under the final rules, a fund must make its disclosures pursuant to Items 7 through 11 of Form N-CSR publicly available, free of charge, at the website address specified at the beginning of its shareholder report. Alternatively, the fund may post the complete Form N-CSR. The FAQ provided that:

- Information responsive to Items 7-11 may be grouped by series and/or type of materials, and need not be presented individually by share class, so long as it:

  - effectively communicates the information;
  - clearly distinguishes the materials and/or series; and
  - provides a means of easily locating information (*i.e.*, table of contents that includes hyperlinks).
- Posting the required Form N-CSR information online will not be a violation of Rule 502(c) of Regulation D, so long as the fund posts only the information required by the rule and does not use its website to offer or sell securities or in a manner that is deemed to be general solicitation or advertising for offers or sales of its securities.

Binding Individual Shareholder Reports of Multiple Funds

- Where an investor has invested in multiple funds (or in multiple share classes of funds), the individual shareholder reports of each of such funds (or, as applicable, share classes) may be bound, stapled, or stitched together for transmission to the investor because such practice does not raise the same concerns about multiple series shareholder reports that the SEC discussed in the Adopting Release. The Staff notes that a fund should consider including a table of contents to any bound, stapled, or stitched shareholder report for investors' ease of use.

Electronically Provided Shareholder Reports

- There is more than one approach that would be consistent with the requirements of Instruction 4 to Item 27A(a) of Form N-1A for a fund to deliver its fund and share-class specific shareholder report directly to an investor, including delivering an email, or otherwise electronically transmitting a notification to investors, that (i) includes direct links to the shareholder report(s) of the fund(s) and share class(es) that the investor owns, and (ii) specifies the investor's fund(s) and share-class(es) and includes a link directing the investor to a website page that includes direct links that are limited to the shareholder report(s) for the fund(s) and share class(es) that the investor owns.

Compliance Date and Inline XBRL Issues

- The funds should include the shareholder report that was actually transmitted to shareholders in the respective Form N-CSR, regardless of whether the Form N-CSR is filed before or after the compliance date (*i.e.*, July 24, 2024).

While these responses only represent the views of the Staff and have no legal force or effect, they provide clarity and guidance on questions regarding certain elements of the rule.

Tailored Shareholder Reports Frequently Asked Questions (Jan. 26, 2024), available at: https://www.sec.gov/investment/tailored-shareholder-reports-faqs.

Tailored Shareholder Reports for Mutual Funds and Exchange-Traded Funds; Fee Information in Investment Company Advertisements, SEC. Rel. Nos. 33-11125; 34-96158 (Oct. 26, 2022), available at: https://www.sec.gov/files/rules/final/2022/33-11125.pdf.

Industry Developments

FinCEN Proposes AML Rules for Investment Advisers for the Third Time

The U.S. Department of the Treasury's Financial Crimes Enforcement Network recently proposed a rule that would require SEC registered investment advisers, as well as those that report to the SEC as exempt reporting advisers, to implement AML and countering the financing of terrorism programs.

The proposed rule adds investment advisers to the list of businesses classified as "financial institutions" under the Bank Secrecy Act and would require advisers to also file suspicious activity reports, fulfill certain recordkeeping requirements, and fulfill other obligations applicable to financial institutions subject to the Bank Secrecy Act and FinCEN's implementing regulations. The proposed rule also applies information-sharing provisions between and among FinCEN, law enforcement government agencies, and certain financial institutions, and delegates examination authority for this rule to the SEC.

The proposed rule is the third time that FinCEN has attempted to impose AML rules on the investment advisor sector and is tailored towards addressing material risks and strengthening financial transparency while minimizing potential business burden as much as possible. Rules previously proposed in 2003 and 2015 were never finalized.

The proposed rule is subject to comment until April 15, 2024. If the proposed rule is adopted, investment advisers would have 12 months to comply.

Financial Crimes Enforcement Network: Anti-Money Laundering/ Countering the Financing of Terrorism Program and Suspicious Activity Report Filing Requirements for Registered Investment Advisers and Exempt Reporting Advisers, RIN 1506–AB58 (Feb. 15, 2024), available at: https://www.govinfo.gov/content/pkg/FR-2024-02-15/pdf/2024-02854.pdf.

Natasha Vij Greiner Replaces William Birdthistle as Director of IM

On February 28, 2024, the SEC announced the appointment of Natasha Vij Greiner as the new Director of the Division of Investment Management. Greiner, the former Deputy Director of the SEC's Division of Examinations, replaced William Birdthistle following his departure from the SEC on March 8, 2024. "Natasha brings deep and broad expertise to the Division, both having led the agency's Investment Adviser/Investment Company examination program and having served in other key leadership roles over her more than two decades at the SEC," said SEC Chair Gary Gensler. Simpson Thacher Partner David Blass, who worked closely with Ms. Greiner

while he was at the SEC, said "Natasha is smart and highly capable. She has extensive experience across the SEC—policy, examination, and enforcement roles. We should expect her to be a no-nonsense, but fair and well-informed head of the Division of Investment Management."

Press Release, *SEC Announces Departure of William Birdthistle; Natasha Vij Greiner Named Director of the Division of Investment Management* (Feb. 28, 2024), available at: https://www.sec.gov/news/press-release/2024-27.

A Landmark Decision for the Cryptocurrency Markets—SEC Approves Spot Bitcoin ETFs

After denying more than twenty applications requesting the listing of spot bitcoin ETFs over the last decade, on January 10, 2024, the SEC approved eleven such applications authorizing the listing of the first U.S. ETFs that will hold bitcoin. The tide change began with Grayscale Investments, LLC filing a lawsuit against the SEC in June 2022 as a result of the SEC's repeated denial of Grayscale's bids to convert its Bitcoin Trust into a spot bitcoin ETF through a listing application. In August 2023, the U.S. Court of Appeals for the District of Columbia Circuit ruled in favor of Grayscale, holding that the SEC failed to adequately explain its reasoning in denying Grayscale's listing application.

The decision was approved by a 3-2 SEC vote. As a result, U.S.-based institutional and retail investors will now be able to purchase securities that provide direct exposure to the spot bitcoin market without having to custody bitcoin themselves. Following the landmark decision, SEC Chair Gary Gensler announced that approval was "the most sustainable path forward," while making clear that the SEC's approval only applies to ETFs holding one non-security commodity—bitcoin—and should not be considered a signal of the SEC's views regarding any other digital assets. He also noted that the SEC's approval provides certain investor protections, such as (i) full, fair, and truthful disclosure about spot bitcoin ETFs in public registration statements and required periodic filings; (ii) the rules of the national securities exchanges that are designed to prevent fraud and manipulation; and (iii) the existing rules and standards of conduct, such as Reg BI, made applicable to the purchase and sale of the approved ETFs.

SEC Commissioner Hester M. Peirce concurred with the SEC's decision stating that the SEC "squandered a decade of opportunities" to do its job and that spot bitcoin ETFs could have been approved years ago but for the SEC's refusal to do so until a court called its "bluff."

SEC Commissioner Mark Uyeda also concurred with the SEC's decision but expressed his concerns with the underlying analytical approach, noting what he viewed as the SEC's disparate treatment of spot bitcoin ETFs relative to other products and the invention of a "novel, unarticulated standard" to form the basis of approval.

SEC Commissioner Caroline Crenshaw, however, reiterated the SEC's previous concerns about the spot bitcoin market's potential for "fraud and manipulation," as well as a concentration of ownership and lack of unified oversight in the bitcoin market. She stated that the SEC's ruling is "unsound and ahistorical, and worse, they put us on a wayward path that could further sacrifice investor protection."

The issuers of the ETFs approved by the SEC were Grayscale Investments, LLC, Bitwise Investment Advisers, LLC, Hashdex Asset Management, Ltd., iShares Delaware Trust Sponsor LLC, Valkyrie Digital Assets, LLC, 21Shares US LLC, Invesco Capital Management LLC, Van Eck Digital Assets, LLC, WisdomTree Digital Commodity Services, LLC, FD Funds Management LLC and Franklin Holdings, LLC.

Gary Gensler, SEC Chair, *Statement on the Approval of Spot Bitcoin Exchange-Traded Products* (Jan. 10, 2024), available at: https://www.sec.gov/news/statement/gensler-statement-spot-bitcoin-011023.

Caroline A. Crenshaw, SEC Commissioner, *Statement Dissenting from Approval of Proposed Rule Changes to List and Trade Spot Bitcoin Exchange-Traded Products* (Jan. 10, 2024), available at: https://www.sec.gov/news/statement/crenshaw-statement-spot-bitcoin-011023.

Hester M. Peirce, SEC Commissioner, *Statement on Omnibus Approval Order for List and Trade Bitcoin-Based Commodity-Based Trust Shares and Trust Units* (Jan. 10, 2024), available at: https://www.sec.gov/news/statement/peirce-statement-spot-bitcoin-011023.

Mark T. Uyeda, SEC Commissioner, *Statement Regarding the Commission's Approval of Proposed Rule Changes to List and Trade Shares of Spot Bitcoin Exchange-Traded Products* (Jan 10, 2024), available at: https://www.sec.gov/news/statement/uyeda-statement-spot-bitcoin-011023.

SEC Enforcement

SEC Fines Two Advisers for “AI Washing”

The SEC settled charges against two registered investment advisers for making false and misleading statements about their use of AI, which the SEC refers to as “AI washing.” By analogy, the SEC has pursued “greenwashing” cases in connection with false and misleading statements about ESG, which has been anticipated to provide a playbook for the SEC to pursue AI-related perceived disclosure failures.

According to the SEC’s Order, one RIA made false and misleading statements regarding its use of AI in its Form ADV Part 2A brochures, in a press release, and on its website, a sampling of which is as follows:

- That the RIA’s advice was “powered by the insights it makes when individuals . . . connect their social media, banking, and other accounts . . . or respond to [RIA] questionnaires” which make its investment decisions “more robust and accurate”;
- That client data was used in “a predictive algorithmic model” for the selection of investments;
- That the RIA “uses machine learning to analyze the collective data shared by its members to make intelligent investment decisions”; and
- That the RIA puts “collective data to work to make our artificial intelligence smarter so it can predict which companies and trends are about to make it big and invest in them before everyone else.”

The Order alleged that the RIA had not developed the stated capabilities and noted that in 2021, the RIA had conceded during an examination that it had not created an algorithm to use client data nor otherwise used the client data. The Order detailed post-examination remediation undertaken by the RIA, including corrective disclosure, onboarding a compliance manager, and retaining compliance consultants. However, the Order found that the RIA continued to make false and misleading statements in email communications, on social media, and in a press release through August 2023, as follows:

- That client data was helping train the RIA’s “algorithm for pursuing ever better returns” and was pooled “to power [the RIA’s] algorithm”;
- That the RIA’s “proprietary algorithm uses the data being invested by our members, so we can make stock selections across thousands of publicly traded companies up to seven financial quarters in the future”; and
- That the RIA’s “proprietary algorithms combine the data invested by its members with commercially available data, to make predictions across thousands of publicly traded companies up to two years into the future.”

The second settlement involved an RIA that was an internet investment adviser to retail clients, on similar conduct (as well as other conduct unrelated to statements concerning AI). The Order found that the RIA made false and misleading statements on social media, on its website, and in emails to current and prospective clients, with certain AI-related statements as follows:

- That the RIA's technology incorporated "expert AI-driven forecasts;" and
- That the RIA was the "first regulated AI financial advisor."

The Orders found that the RIAs violated both the anti-fraud provisions and the Marketing Rule of the Advisers Act. Without admitting or denying the SEC's findings, the RIAs each agreed to the entry of an order finding that they violated the Advisers Act, a cease-and-desist order, a censure, and a civil monetary penalty with combined penalties of $400,000.

In the SEC press release accompanying the two settlements, SEC Chair Gary Gensler commented that the two RIAs "marketed to their clients and prospective clients that they were using AI in certain ways when, in fact, they were not. We've seen time and again that when new technologies come along, they can create buzz from investors as well as false claims by those purporting to use those new technologies. Investment advisers should not mislead the public by saying they are using an AI model when they are not. Such AI washing hurts investors." Enforcement Director Gurbir Grewal gave a similar warning in the press release, stating that "if you claim to use AI in your investment processes, you need to ensure that your representations are not false and misleading."

While the settlements involved retail investors, and focused on fairly straightforward disclosure failures, the SEC's current focus on AI is expansive and extends beyond advisers to retail clients. SEC officials have stated publicly that they are scraping registrants' publicly available statements (*e.g.*, Form ADVs, websites) about their use of AI and that AI is going to be a larger part of the examination program this year—and such commentary is not limited to advisers to retail clients. Also, notably, though these settlements did not involve public issuers, Grewal's press release comments included the following warning to those entities: "And public issuers making claims about their AI adoption must also remain vigilant about similar misstatements that may be material to individuals' investing decisions."

In the Matter of Delphia (USA) Inc., SEC Admin. File No. 3-21894 (Mar. 18, 2024), available at: https://www.sec.gov/files/litigation/admin/2024/ia-6573.pdf.

In the Matter of Global Predictions Inc., SEC Admin. File No. 3-21895 (Mar. 18, 2024), available at: https://www.sec.gov/files/litigation/admin/2024/ia-6574.pdf.

SEC Settles With Adviser for Failing to Disclose Fee Arrangement With Influencer Related to ETF Launch

The SEC settled charges against an RIA for failing to disclose a social media influencer's role and the related fee arrangement with an index provider in connection with the board of trustees' approval of the management fee and launch of a new ETF.

According to the Order, the RIA and the proposed index provider initially agreed that the RIA would pay the index provider a licensing fee equal to 20% of the management fee it received from the ETF in exchange for an exclusive license for the index. Thereafter though, the index provider made plans to partner with a well-known and "controversial" social media influencer known for commenting on "sports, investing, and other topics" and proposed new terms to the licensing agreement whereby the index provider would receive a sliding 20% to 60% of the RIA's net management fee from the ETF depending on the ETF's assets under management within 18 months of the ETF's launch. Additionally, the influencer would receive an ownership interest in the index provider for his promotion activities.

At the ETF's organizational meeting, the ETF as well as the investment management agreement were approved by the board. However, according to the Order, the independent trustees were not fully informed of the anticipated economic terms of the licensing arrangement or the planned involvement of the influencer, the compensation to be paid to the influencer, and the controversies surrounding the influencer.

Based on the foregoing, the SEC found that the RIA willfully violated Section 15(c) of the Investment Company Act, which imposes a duty on an investment adviser to furnish such information as may reasonably be necessary for the trustees to evaluate the terms of the investment adviser's contract. Furthermore, the SEC found that the RIA violated the Advisers Act and the rules thereunder by failing to adopt and implement adequate policies and procedures related to furnishing the board with accurate information reasonably necessary for the board to evaluate the terms of the advisory contract, as well as material information related to a proposed fund launch.

Without admitting or denying the findings, the RIA agreed to a cease-and-desist order, censure, and $1.75 million civil monetary penalty.

In the Matter of Van Eck Associates Corporation, SEC Admin. File No. 3-21857 (Feb. 16, 2024), available at: https://www.sec.gov/files/litigation/admin/2024/ic-35132.pdf.

SEC Settles With Sixteen Firms for Widespread Recordkeeping Violations

The SEC recently settled charges against sixteen firms, including five broker-dealers, seven dually registered broker-dealers and investment advisers, and four affiliated investment advisers, for recordkeeping failures related to their employees' use of personal devices in connection with firm business.

According to the Orders, from at least 2019 or 2020, the firms' employees conducted business through their personal text messages and other text messaging platforms, such as WhatsApp, without maintaining or preserving the substantial majority of these off-channel written communications in violation of the federal securities laws. The Orders stated that the failures were firm-wide and involved employees at various levels of authority, including supervisors and senior managers. The Orders also stated that during this time, most of the firms received and responded to SEC subpoenas for documents and records requests in several SEC investigations, which likely impacted the SEC's investigations and ability to carry out regulatory functions. The Staff uncovered the firms' misconduct after commencing a risk-based initiative to investigate the proper retention of business-related communications via personal devices.

Each firm was charged with violating certain recordkeeping provisions of the Advisers Act and Exchange Act, as applicable, and with failing to reasonably supervise with a view to preventing and detecting those violations. Admitting the SEC's findings and acknowledging that their conduct violated the recordkeeping provisions of the federal securities laws, each firm agreed to, among other things, a cease-and-desist order from future violations of the relevant recordkeeping provisions, a censure, and an order to retain an independent compliance consultant to, among other things, conduct comprehensive reviews of their policies and procedures relating to the retention of electronic communications found on personal devices and their respective frameworks for addressing non-compliance by their employees with those policies and procedures. The firms also agreed to civil monetary penalties totaling a combined amount of $81 million (with penalties ranging from $1.25 million to $16.5 million) and have begun implementing improvements to their compliance policies and procedures to address the violations. Notably, the Staff emphasized that self-reporting was a significant factor considered in setting the firms' penalty amounts.

In the Matter of Certain Broker-Dealer Practices, (Feb. 9, 2024), available at: https://www.sec.gov/files/rules/other/2024/33-11270.pdf.

In the Matter of Northwestern Mutual Investment Services, LLC, Northwestern Mutual Investment Management Company, LLC, and Mason Street Advisors, LLC, SEC Admin. File No. 3-21850 (Feb. 9, 2024), available at: https://www.sec.gov/files/litigation/admin/2024/34-99501.pdf.

In the Matter of Guggenheim Securities LLC and Guggenheim Partners Investment Management LLC, SEC Admin. File No. 3-21851 (Feb. 9, 2024), available at: https://www.sec.gov/files/litigation/admin/2024/34-99502.pdf.

In the Matter of Oppenheimer & Co. Inc., SEC Admin. File No. 3-21852 (Feb. 9, 2024), available at: https://www.sec.gov/files/litigation/admin/2024/34-99503.pdf.

In the Matter of Cambridge Investment Research, Inc. and Cambridge Investment Research Advisors, Inc., SEC Admin. File No. 3-21847 (Feb. 9, 2024), available at: https://www.sec.gov/files/litigation/admin/2024/34-99498.pdf.

In the Matter of Key Investment Services LLC, and KeyBanc Capital Markets Inc., SEC Admin. File No. 3-21849 (Feb. 9, 2024), available at: https://www.sec.gov/files/litigation/admin/2024/34-99500.pdf.

In the Matter of Lincoln Financial Advisors Corporation and Lincoln Financial Securities Corporation, SEC Admin. File No. 3-21848 (Feb. 9, 2024), available at: https://www.sec.gov/files/litigation/admin/2024/34-99499.pdf.

In the Matter of U.S. Bancorp Investments, Inc., SEC Admin. File No. 3-21854 (Feb. 9, 2024), available at: https://www.sec.gov/files/litigation/admin/2024/34-99505.pdf.

In the Matter of The Huntington Investment Company, Huntington Securities, Inc., and Capstone Capital Markets LLC, SEC Admin. File No. 3-21853 (Feb. 9, 2024), available at: https://www.sec.gov/files/litigation/admin/2024/34-99504.pdf.

SEC Settles Whistleblower Violations

The SEC settled charges against a dually registered investment adviser and broker-dealer for preventing hundreds of brokerage customers and advisory clients from reporting potential securities law violations to the SEC.

According to the Order, from 2020 through July 2023, the firm regularly required retail clients who received a credit or settlement of more than $1,000 from the firm to sign release agreements that made all underlying facts related to the settlement confidential. Although the agreements permitted clients to respond to SEC inquiries, they prohibited clients from voluntarily contacting the SEC to report violations. Since 2020, at least 362 firm clients signed a release in connection with settlement amounts that ranged from approximately $1,000 to $165,000.

The Order found that the firm violated the whistleblower protection rule under the Exchange Act, which prohibits taking any action to impede an individual from communicating directly with the SEC Staff about possible securities law violations, including by enforcing, or threatening to enforce, a confidentiality agreement. Without admitting or denying the findings, the firm agreed to a censure, cease-and-desist order, and $18 million civil monetary penalty. The Order noted that the SEC considered the remedial actions taken by the firm, which included promptly revising the release agreements to affirmatively advise clients, and notifying clients that

entered into such release agreements, that they were not prohibited from disclosing any information to a governmental or regulatory authority.

In the Matter of J.P. Morgan Securities LLC, SEC Admin. File No. 3-21829 (Jan. 16, 2024), available at: https://www.sec.gov/files/litigation/admin/2024/34-99344.pdf.

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