Regulatory Compliance Watch

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Funds' names rule amendments approved

If you walk into a pizzeria, you expect to be able to order pizza.

SEC Commissioner **Hester Peirce** noted such in supporting the Commission's approval—by a 4-1 vote—Sept. 20th of a ***new revision*** to the more than 20-year-old so called names rule. The changes to Investment Company Act ***rule 35d-1*** (investment company names) "will help ensure that a fund's portfolio matches a fund's name," added SEC Chairman **Gary Gensler**.

"A fund's name is the first data point an investor encounters when weighing investment options," said Commissioner **Jaime Lizárraga**. The ***revised rule*** will help prevent a fund from "calling itself a name that is misleading, deceptive or inconsistent with its investments," he added, mentioning greenwashing of a supposed ESG fund.

The lone holdout—at the Commission's first full public meeting at its Washington, D.C. headquarters since the pandemic began—was Commissioner **Mark Uyeda**. He stated the revised rule will overemphasize the "importance of a fund's name, as it suggests that investors, and their financial advisers, need not look at the prospectus disclosures." The amendments also will come with "significant compliance costs," he warned.

In response to a question from Uyeda, an SEC staffer said an adviser's fiduciary duty would hold it to look beyond a fund's name to dig into a prospectus to ensure its portfolio is appropriate for a client.

What's inside the new rule

The Commission ***proposed*** the new rule last year (***RCW***, May 25, 2022). It would hand adviser CCOs a fistful of new duties (***RCW***, June 2, 2022). For instance, a fund would have to have a new P&P mandating it invest at least 80% of its assets in accordance with its name. There also would be enhanced disclosures required, including how a fund defines key terms tied to its name. Related records also would have to be kept.

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There were changes to the final rule from the initial proposal. The proposal called for more frequent monitoring of a fund's portfolio to ensure it's operating within the 80% threshold. The final rule will insist on only at least quarterly assessments.

Revised disclosures

Form N-PORT would be revised to disclose more about a fund's investments. Funds investing in derivatives would have to use their notational value as opposed to their market value. Should portfolio drift take a fund away from its required 80% threshold, it would generally have 90 days to come back into compliance.

While the new rule won't affect target date funds, it will fall upon most other mutual funds and business development companies. In some cases, a closed-end fund or a BDC wouldn't be able to change its 80% policy without a shareholder vote.

The new revised rule becomes effective 60 days after it's published in the *Federal Register*, but you'll have plenty of time to comply. Funds with net assets above $1 billion will have 12 months from that effective date, while smaller funds will have 18 months to comply.

Why now?

Gensler noted "gaps" in the 22-year-old rule along with the tremendous growth in the funds' market since 2001 in justifying revising the names rule. Lizárraga said the changes will benefit up to 120 million retail investors in the U.S.

Uyeda noted SEC staff spend an inordinate time now policing fund names and the new changes will only "exacerbate" this. He also requested staff release guidance on how it will supervise the industry's compliance with the newly revised rule.

*What do you think about this story? Please, **share your thoughts** with Publisher* **Carl Ayers**. ■

Safeguarding proposal concerns expressed

A band of 26 industry groups has sent a ***letter*** to **SEC** Chairman **Gary Gensler** urging the Commission not to adopt the controversial *Safeguarding Advisory Client Assets* ***proposed rule***. The group asserts that the proposal, whose comment period was extended for another 60 days on Aug. 23, "creates a wide range of negative consequences across the U.S. financial markets." The proposal "will result in a myriad of negative impacts on investors, including their access to various services, assets, and markets with well-established rules and procedures," the group writes.

Back in February, SEC commissioners voted 4-1 to approve the safeguarding rule proposal that would

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Lobbying stepped up on safeguarding proposal

Industry advocates have clearly been making the rounds on Capitol Hill to weigh in on the **SEC**'s controversial proposed safeguarding rule. At a House oversight Sept. 19, members from both parties lined up to tell SEC Investment Management Division Director **William Birdthistle** they were unhappy with the ***custody proposal*** (see related story, page 2).

"The concern is that the Commission is inserting itself into matters at the core of the banking system squarely within the jurisdiction of the prudential regulators—the segregation of clients' cash having effects on monetary policy and bank recovery and resolution frameworks," U.S. Rep. **Dan Meuser**, R-Pa.., said.

Missouri Democrat **Emanuel Cleaver** said he was worried the proposal's language defining mortgages and deeds as assets requiring custody rules "could upend" America's already wobbly real estate market. "I'm trying to make sure we do nothing to interfere with people getting homes," he said.

Definition of assets

Real estate is indeed defined as an asset under the safeguarding proposal, but it's also exempted by the proposals, Birdthistle told the panel.

Arkansas Republican **French Hill**—a former broker-dealer—said the new custody proposal "goes against common law, it goes against the very traditions of commercial banking and trust banking rules of what is custody."

Hill was one of at least three Republicans to ask Birdthistle about the Commission's conversations with their counterparts in other regulatory agencies. In the months before the SEC proposed the safeguarding rule, regulators from the **Office of the Comptroller of the Currency** warned the SEC that the rules might sow confusion in the banking industry. The indemnification language, especially, was "in-artfully" written, OCC staffers told their SEC counterparts, government sources said, speaking on condition of anonymity.

eliminate the custody rule—Investment Advisers Act ***rule 206(4)-2***—and replace it with new Advisers Act ***rule 223-1*** (***RCW***, Feb. 16, 2023). In voting for the rule proposal, Gensler said it would "help ensure that advisers don't inappropriately use, lose or abuse investor assets."

Comment period reopening

The trigger for the reopening of the proposed rule's comment period was the adoption of the private fund advisers audit rule (***RCW***, Aug. 23, 2022). That rule requires a registered investment adviser to obtain an ***annual*** financial statement audit of each private fund it advises in accordance with the audit provision of the current custody rule. The Commission reasoned that the reopening will allow additional time for the assessment of the proposed amendments to the current custody rule's audit provision in light of the private fund adviser audit rule.

The industry group of trade associations submits that the proposed rule would create requirements that are "inconsistent with, and duplicative of, existing safeguards enforced by the **Commodity Futures Trading Commission**, federal banking agencies, and state insurance regulators, as well as certain preexisting SEC requirements." The group trains its attention on "four fundamental changes" to the current custody framework that the associations believe don't have a "clear policy rationale."

'Four fundamental changes'

The four changes addressed in the letter to Gensler include:

1. Compelling qualified custodians to segregate client assets, including cash deposits, variation margin, and contractual obligations, in a manner at odds with the existing regulatory frameworks that cover the related institutions and instruments.

2. The creation of an "overly broad" definition of "custody" that includes many adviser practices that are already "heavily regulated."

3. Expanding the rule's application from "funds and securities" to all positions held in a client account.

4. Compelling advisers to enter into contractual agreements with custodians and the imposition on these custodians of a host of new commercial and operational requirements that "may be impossible to fulfill."

Potential adverse effects

A baker's dozen list of adverse effects should rule 223-1 be finalized dominates the letter. The perceived issues flagged included:

- The proposal would result in higher fees for custodial services.

- The imposition of "substantial burden" on investment advisers and their compliance personnel.
- The disruption of the core banking model of taking deposits, providing credit, and facilitating payments.
- The disproportionate burdening of smaller firms.
- The creation of "significant operational and practical challenges" to the custody of real estate.
- Expanded definitions of "custody" and "assets" creating conflicts with state insurance laws governing annuities.
- Restricting investors' ability to invest in "emerging and frontier markets through investment advisers."

Substantial industry feedback

The SEC has certainly heard an ***earful*** and then some on the safeguarding proposal from others, as well. Nearly 200 commentors have weighed in to date and senior Commission staff have participated in 64 in-person meetings and video conferences with industry. Members of the group, including **SIFMA**, the **ICI**, the **MFA**, and the **Futures Industry Association**, have met with SEC representatives on the issue.

With over 5,000 additional advisers potentially being subject to new custody requirements, the stakes are high (***RCW***, June 29, 2023). The trade groups ultimately believe that "material changes to substantial components" of the proposed rule are necessary. "Should the Commission decide to make such changes and move forward with rulemaking, we strongly recommend withdrawing and re-proposing the proposal," the groups state in their new letter. ■

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Lessons aplenty in 'massive' Ponzi scheme

As **John Woods** stares at a possible 20-year prison term for a "massive" Ponzi scheme that cost investors at least $25 million—many of them elderly, who were depleted of their lifesavings—the case raises questions about whether more could have been done—by compliance personnel and the **SEC**—to have uncovered the fraud years earlier.

Consider that the SEC conducted two examinations of Woods' advisory firm in the years leading up to when his scheme unraveled in 2021, and Woods' employer, **Oppenheimer & Co.** ($22B in AUM) in New York, had enough qualms about him that it led to his resignation in 2016. Yet, authorities say his Ponzi scheme, which began in 2008, continued unabated for another five years, during which time Woods took in as much as $600,000 a month from unwitting investors.

Woods, 58, of Marietta, Ga., pleaded guilty in federal court in Atlanta in March to wire fraud and is awaiting sentencing. Both he and his attorneys declined to talk on the record with ***RCW***. Recently, the SEC ***barred*** him for his crimes, but these actions came too late for the more than 400 investors from 20 different states who were taken in by him (***RCW***, Aug. 27, 2021). Last month, the SEC ***charged*** a CPA in connection with the Ponzi scheme.

Lessons for others

Woods' case offers lessons around the need to uncover unauthorized outside business activity, for compliance officers to dig deeper when they detect red flags, to search public records for signs a rep is in trouble, for supervisors to ask the right questions and to report accurately on Forms U5 so others can be warned about dubious reps.

Woods' *BrokerCheck* ***record*** reveals a career that began in 1989 and featured a single blemish in 2008 before exploding in 2021 to a number that tops 50 customer disputes.

"This is really a cautionary tale," says **John Chapman**, a Cleveland attorney who represented investors who sued Oppenheimer over Woods' fraud. "It's peoples' lives getting destroyed financially."

One lesson offered by Chapman: "It's not a prudent practice to try to trim your expenses in the compliance department because the downside of bad supervision is ruinous."

RCW several times asked two compliance officers with Oppenheimer to talk for this story but never received a response.

Missed red flags

Chapman saves much of his clients' fury for Oppenheimer. Woods "was not closely supervised" and staff missed or ignored "abundant red flags" that could have halted the fraud early on, he maintains. For example, public records reveal Woods filed for bankruptcy in 2013. "Had there been a follow up investigation, they would have found this out a lot sooner and saved a lot of people much aggravation," contends Chapman.

His lawsuit asserts the Oppenheimer compliance staff in Atlanta approved money transfers to a private equity fund, Horizon, that Woods created in 2006, as well as transfers in reverse to investors. "The Horizon 'Dividend Account' was unlike any other customer account in the Atlanta branch office, and the Atlanta branch office compliance personnel had never been involved with a similar account," according to the Chapman lawsuit.

"Oppenheimer directly profited from the scheme each and every month from 2008 through 2016 by charging Horizon substantial fees, commissions and margin interest in the Horizon trading accounts," the lawsuit continues, including earning $32,000 in margin interest in one month alone.

Many of the harmed investors were with **Southport Capital**, an RIA in Chattanooga, Tenn. The government's criminal filing against Woods asserts he had Horizon purchase the advisory firm in 2008 but hid the acquisition from his employer. The RIA terminated its registration last year.

The government states Woods had "a family member" manage Southport. The SEC says Horizon had no staff or offices and that "all of its activities" were performed by Woods and Southport staff. Chapman contends Woods worked out of Oppenheimer's Atlanta office.

Warning signs appear

According to the Chapman lawsuit, between 2008 and 2016, "excessive trading and massive losses generated in the Horizon trading accounts at Oppenheimer triggered multiple compliance 'alerts.'" However, "Oppenheimer's compliance department never took any steps to stop Woods," at least until late 2014.

In 2011, the SEC conducted an exam that "inquired about the excessive trading in the Horizon trading accounts." Compliance staff e-mailed examiners, stating that "Horizon was a private hedge fund run by an investment professional that was directing all trades," legal documents show.

Smoke billowed years before, argues Chapman. Two lawsuits, which would have been publicly available, targeted Woods as far back as 2008. Oppenheimer would have been "aware of that because they were served with a subpoena," Chapman tells ***RCW***. "It should have been a three-alarm fire."

Compliance concerns were finally building. In late 2014, compliance staff urged the president of Oppenheimer's private wealth division to drop the Horizon account. When that official failed to act, compliance went to the CEO, who eventually ordered Horizon to be transferred to a different firm.

A rogue's gallery

Oppenheimer has a checkered record in working with suspect reps. A study from 2016 looking at ***The Market for Financial Adviser Misconduct*** placed the firm at the top of the list—with the highest incidents of misconduct. Almost "one in five financial advisers at Oppenheimer & Co" displayed "a record of past misconduct," the study reads. The firm's past record has even attracted the ire of SEC commissioners (***RCW***, Feb. 12, 2015).

Oppenheimer's latest Form ADV brochure fails to mention Woods but it carries nearly five pages of disclosed disciplinary issues.

Hop to 2016, when Oppenheimer gets wind of Woods' undisclosed outside business activity thanks to a lawsuit in which the owner of a firm Woods acquired sued him. Oppenheimer allowed Woods "to quietly resign," the Chapman lawsuit asserts. Woods' direct supervisor also left. However, Chapman contends Oppenheimer didn't alert regulators. Instead, the firm "gave him a clean U5," he says. "I would argue that [the fraud] would have been shut down early" had Oppenheimer accurately "lit up" Woods' U5, he maintains.

The founder who sued Woods believes Oppenheimer's compliance staff never talked with him.

In 2018, SEC examiners showed up at Southport with questions. The SEC reports the adviser's CCO e-mailed Woods' responses. Commission staff now contend those responses were lies, but no apparent action was taken at the time. Examiners returned in 2021 to examine Southport yet again, and then the gig was up.

The SEC has ***fined advisers*** for failing to supervise reps who operated frauds. There's no indication of any enforcement action tied to Oppenheimer stemming from the Woods' fraud—despite its history of reps with misconduct as seen in that study—and the SEC concedes that Woods was able to continue to fleece investors long after he left the firm.

Actions to take

Whenever your "suspicions are raised" about a staffer, "keep asking questions until every question is answered fully," counsels Chapman.

While smart bad guys can fool their employer—and even the SEC—red flags should prompt inquiries. For instance, Woods rarely used his Oppenheimer e-mail address, preferring an outside one, says Chapman. E-mail serves as a critical tool for compliance, and rare use of the company e-mail should have sparked concerns, he adds.

Chapman wishes that Oppenheimer's compliance staff could have heard his clients' testimony, so they could "understand how their supervisory failures can really trigger human tragedies."

What do you think about this story? Please, share your thoughts with Publisher **Carl Ayers**. ■

Adviser charged over fiduciary duty breach

Complex products have a way of attracting **SEC** attention. The Commission's Division of Examinations clearly signaled in its *2023 Examination Priorities* ***report*** that its examiners would be monitoring "the proliferation of volatility-linked and single-stock" exchange traded funds. A small New York-based investment adviser has surely gotten the message.

Summit Planning Group ($101M in AUM) and its President/CCO **Richard Urciuoli** were charged Sept. 18 with, among other things, failing to adopt or implement written P&Ps that were "reasonably designed" to ensure that it understood the material features and risks of complex products—like a volatility linked exchange product (VXX) it invested clients in—before purchasing them for advisory clients.

P&Ps lacking

The enforcement action offers lessons. The Commission's ***settlement agreement***—in which Summit Planning and Urciuoli neither admit or deny the SEC's findings—notes that, although Summit Planning permitted purchases of complex products like VXX, the firm's P&Ps did not address due diligence, suitability assessments for these products, or procedures for monitoring such investments.

The SEC pins the issues directly on Urciuoli. He wore all the firm's hats as sole owner, investment adviser rep, president and CCO and was responsible for all of Summit's investment and compliance decisions and ultimately "was responsible for Summit's failures," the Commission stated.

Suitability issues

It is critical to understand and vet the features of complex products. Suitability was called into question in the case. The SEC stated that because Summit Planning and Urciuoli "failed to adequately consider the fundamental investment characteristics of VXX," they invested advisory client money in VXX in an unsuitable manner.

The SEC found that the parties invested client assets in VXX for extended periods of time "without having a reasonable basis to do so." Nearly two-thirds of Summit Planning's client accounts invested in a 3% position in VXX. Half of the VXX position was sold 34 trading days after purchase and the remaining position was sold after 86 trading days.

Inconsistencies cited

The timeline was the issue. The SEC charged the trading conduct was "inconsistent with VXX's prospectus and pricing supplement, which stated that the product carried unique risks, was designed to be held for very short time periods, likely would incur costs if held for more than one trading session, and required frequent monitoring." The client accounts holding VXX collectively lost over $443,809 from these investments, the SEC noted.

The enforcement action will also cost Summit Planning and Urciuoli. Under the settlement agreement, they will both pay $100,000 penalties. ■

Attorney-client privilege: Fiduciary exception

Washington's increased focus on private funds may send fund managers scurrying to their lawyers for advice on how best to adapt to new rules and regulations, but managers should remember that not all their attorney-client communications may stay secret, experts say.

"When you've got more disclosure, more regulation, you're going to have more interaction between funds and their counsel," says **David Rose**, a partner with **Pryor Cashman**. "That could open things up down the road for a disgruntled LP to say, 'Hey, what were you talking about?'"

The notion of attorney-client privilege ***predates*** the Roman empire. American courts generally agree that lawyers' advice should be between the lawyers and their clients. There are exceptions, though (***RCW***, Nov. 14, 2019). A notorious one is the so-called "***crime-fraud***" exception, where a client doesn't have a right to assert privilege if the legal advice they're getting helps them perpetrate fraud.

Another exception is the ***fiduciary exception*** – where courts reason that because a fund manager is getting legal advice in his or her capacity as fiduciary to the funds, the advice is ultimately being provided to the fund's investors. That's one way that plaintiffs can get access to otherwise privileged records, Rose says.

"As a fiduciary, when I'm seeking advice of counsel regarding fund operations, I'm not doing it for my own sake. I'm doing it on behalf of those people who are investing in the fund," he says. "Those beneficiaries have every right to know what that lawyer said and how it impacts my fiduciary duty."

'Treasure troves' of information

It can become a kind of negative feedback loop, Rose and others say. Consider antitrust law. In the past few years, the **Federal Trade Commission** and the **Department of Justice** have each ***ratcheted*** up their scrutiny of mergers and acquisitions. Officials in both agencies have made clear they ***see*** private equity "roll-ups"—especially in the health care industry—as a problem to be addressed.

Suppose a fund manager is thinking about buying up some elder care clinics. The manager asks the fund's lawyers for advice on getting the merger through Washington's now-more-arduous review process. If regulators later block the merger, and the fund must abandon the deal, it's at least thinkable that an LP would sue for breach of fiduciary duty and ask to see the e-mails between the fund and the fund's counsel about the aborted healthcare deal.

"The possibility of enhanced communication among counsel and fund principals to account for compliance is going to provide fertile ground for this exemption," Rose says. "There will be treasure troves of information, where somebody got advice from counsel to go left, and they went right. Somebody's going to say, 'Hey, I want to know what you did and whether you acted consistently with that advice.' Now you're getting sued for ignoring advice of counsel."

Adam Diederich is a veteran litigator with **ArentFox Schiff**. He says the fiduciary exception is a potential risk, but it's still difficult for investors to obtain attorney-client communications. In his experience, it's not just litigious investors a manager needs to worry about – it's their partners in the fund. In many states—Delaware among them—top executives are generally allowed access to their partners' communications with company attorneys as a matter of corporate law, he says.

"If the two LLC managers are e-mailing the company's lawyer about kicking out the third director – whether it's right or wrong – generally speaking, the third director can probably get access to those records," he says. "The lawyer is a lawyer for the company, and a director or LLC manager embodies that company."

The **SEC** is "clearly getting annoyed" with the way some funds assert their attorney-client privilege, Diederich says.

On page 63289 of the Commission's new private funds rules, passed by a 3-2 vote on Aug. 23, regulators say they've "observed improper claims of the attorney-client privilege, the work-product doctrine, or other similar protections over required records, including any records documenting the annual review under the compliance rule, based on reliance on attorneys working for the adviser in-house or the engagement of law firms and other service providers (e.g., compliance consultants) through law firms. Attempts to improperly shield from, or unnecessarily delay production of any non-privileged record is inconsistent with prompt production obligations and undermines Commission staff's ability to conduct examinations. Prompt access to all records is critical for protecting investors and to an effective and efficient examination program."

Reputational risks

Whatever the legal risk involved in having your attorney-client chats made public, there are certainly reputational risks, Pryor Cashman's Rose says.

"There are all kinds of things that could damage your reputation," he says. "You could come off looking foolish, you could come off looking cavalier. It's that moment where someone says to themself, 'I get it, I don't have a breach-of-fiduciary duty claim, but I'm seeing a lot in these e-mails. If they're this unprofessional with counsel, inside or outside, how professional are they when it comes to the management of my money?'"

These risks aren't just hypothetical. In 2012, after shareholders in several portfolio companies sued 11 private equity firms, accusing them of helping each other keep deal prices low, executives at **KKR** and **Blackstone** handed over dozens of e-mails under confidential seal. A judge ordered them unsealed after a motion from the *New York Times*. The *Times* ***wrote the emails up*** as proof industry players were too cozy with one another. The firms settled the litigation two years later.

So how can firms get the advice they need and not risk having their own lawyers become witnesses against them? Experts offer a few tips:

1. **Remember who the client is.** "Many company executives mistakenly act as if the company's lawyer is their own lawyer," ArentFox's Diederich says. "In most situations, the company's lawyer is not the executive's

lawyer, and this is often stated in the engagement letter between the company and the law firm. The client controls the attorney-client privilege."

2. **Be "thoughtful" about what you put in writing, and when**, Rose says. "Be deliberate about how you talk to counsel," he says. "In this industry in particular, yes, there can be a sense of clubbiness. Yes, relationships matter. But this is a serious business. You're dealing with massive sums of money, and in the case of pensions, you're talking about people who've worked hard to earn that money. Your communications with your counsel, when it relates to legal advice, should be the paramount of professionalism."

3. **Be clear about the "hats" you're wearing**. There can be conflicts between being a compliance officer and a fund general counsel, for instance, (so many that some experts ***believe*** the multi-hatted CCO is an endangered species). When talking with firm lawyers, consider labeling the role in which you're acting in the subject heading and opening line, Rose says. "In my capacity as CCO/CFO…" e-mails might begin, making clear when you're seeking advice acting as a fiduciary and when you're seeking advice for yourself.

4. **"Silo" the counsel**. If you're worried about another firm partner or member, consider forming a special committee, and then hiring a separate attorney to advise that special committee, Diederich says.

5. **Use your own lawyers**. If you're worried about preserving your attorney-client privilege, hire one for yourself, Diederich says. ■