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## SEC Charges Investment Adviser, Officers, and Fund Trustees with Liquidity Rule Violations

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On May 5, 2023, the US Securities and Exchange Commission (SEC or Commission) announced charges against an investment adviser for aiding and abetting violations of Rule 22e-4 (Liquidity Rule) under the Investment Company Act of 1940 (1940 Act) and related reporting requirements by a mutual fund (Fund) it advised and whose liquidity risk management program (LRMP) it administered.<sup>1</sup> The Commission also charged two officers of the adviser and the Fund's two independent trustees with aiding and abetting violations of the Liquidity Rule by the Fund,<sup>2</sup> while the Fund's interested trustee agreed to settle charges that he caused and willfully counseled the Fund's violations.<sup>3</sup> The action is the first case enforcing the Liquidity Rule since its compliance date,<sup>4</sup> and also is noteworthy for the Commission's allegations of liability on the part of independent trustees (as well as the other defendants) for aiding and abetting violations of 1940 Act rules pursuant to Section 48(b) of the 1940 Act (among other provisions).<sup>5</sup>

According to the complaint, from June 2019 to June 2020, the Fund held over 21 percent of its net assets in restricted shares of an issuer (Company) that should have been deemed "illiquid investments" for purposes of the Liquidity Rule. The Commission alleges that the Fund failed to develop a plan to bring

its position in illiquid investments into compliance with the 15 percent net asset limit as required by the Liquidity Rule, and failed to comply with applicable board reporting and SEC filing requirements. The Commission seeks a final judgment: (1) permanently enjoining the defendants from aiding and abetting further violations of the Liquidity Rule and related reporting requirements; and (2) ordering all defendants to pay civil monetary penalties.<sup>6</sup>

### Applicable Provisions of the Liquidity Rule

The Liquidity Rule requires open-end funds (other than money market funds) to manage liquidity risk by, among other things, establishing an LRMP, which is the written framework for classifying the liquidity of portfolio investments "using information obtained after reasonable inquiry and taking into account relevant market, trading, and investment-specific considerations," and according to defined classifications.<sup>7</sup> The Liquidity Rule contains four liquidity classifications for investment assets held by a fund: (1) "highly liquid investment," (2) "moderately liquid investment," (3) "less liquid investment," and (4) "illiquid investment."<sup>8</sup> Of relevance to the complaint, "less liquid investment" is defined as an investment that can be sold or disposed of in seven calendar days or less but where the sale or

disposition is reasonably expected to settle in more than seven calendar days; “illiquid investment” is defined as an investment a 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 fund’s board is responsible for overseeing the LRMP,<sup>9</sup> while the LRMP administrator is responsible for managing the fund’s liquidity risk.<sup>10</sup> The Liquidity Rule expressly requires the board to approve the LRMP, approve the designation of the LRMP administrator, and review, no less frequently than annually, a written report prepared by the LRMP administrator. The LRMP administrator is required to report to the board within one business day after the fund’s illiquid investments exceed 15 percent of net assets. The report must provide an explanation of the extent and causes of the occurrence and how the fund plans to bring its illiquid investments under the 15 percent limit within a reasonable period of time. Further, Rule 30b1-10 under the 1940 Act requires the fund to report the breach in a confidential filing with the Commission on Form NLIQUID (now known as Form NRN) within one business day.

## SEC Allegations

In this case, the complaint alleges that the Fund held over 21 percent of its net assets in shares of the Company from the time the Fund was required to begin to comply with the Liquidity Rule on June 1, 2019 to June 16, 2020, at which point the Fund classified the Company shares as “illiquid investments” and reported them as such, on Form NLIQUID.

Instead of decreasing its illiquid investments to comply with the 15 percent limit, the Fund reclassified the “illiquid investments” as “less liquid investments,” despite the following factors:

- Contractual and legal restrictions on the sale and transfer of Company shares;
- Fund having reported the Company shares as “illiquid” in its shareholder reports and financial statements;
- Fund having received comments from the SEC Staff on the Fund’s Form NCSR filing taking note of the liquidity profile of the Fund’s illiquid investments and asking the Fund to explain how it determined that its investment strategy was appropriate for the open-end structure;
- Views of the Fund’s auditors and legal counsel provided to the Fund’s officers and trustees that: (1) the Company shares were illiquid, (2) there was no basis to classify the shares as “less liquid,” and (3) the Fund was required to implement a plan to comply with the Liquidity Rule’s 15 percent limit; and
- Eventual resignation by the Fund’s auditors and legal counsel over their continuing disagreement with the classification of the Company shares as “less liquid.”

According to the complaint, the adviser and two of its officers were primarily responsible for monitoring the liquidity of the Fund’s assets, classifying the liquidity of such investments in accordance with the Liquidity Rule, and making the required reports to the Fund’s board and related filings with the Commission. The Commission alleges that the adviser and its officers aided and abetted the Fund’s violations by not classifying the Company shares as an “illiquid investment” when the facts required such a classification and failing to make reports to the Fund’s board required by the Liquidity Rule. The complaint further alleges that the Fund, through its officers (and the settling trustee), made false statements to the SEC Staff claiming, among other things, that customers of an affiliated broker-dealer had expressed interest in purchasing the Company shares, when, in fact, none had done so.

The Commission alleges that the Fund’s board, including its independent trustees, aided and abetted the Fund’s violations by knowingly or recklessly failing to exercise reasonable oversight of the LRMP. According to the complaint, the independent trustees, as members of the Fund’s valuation and audit committees, frequently discussed the challenges

of valuing the Company shares during committee meetings and were “keenly aware of the facts that rendered the shares illiquid.”<sup>11</sup>

Additionally, the Commission alleges that the Fund violated Rule 30b1-10 by failing to report on Form NLIQUID when the Fund’s illiquid investments breached the 15 percent limit. The Commission also alleges that the adviser and its officers aided and abetted the Fund’s violations of Rule 30b1-10.

## Key Takeaways

There are a number of factors unique to this case that suggest that it may not be a harbinger of similar enforcement cases to be brought under the Liquidity Rule against independent trustees generally or against other industry participants, particularly fund complexes with well-developed compliance, board governance and disclosure-related policies and procedures. Factors that may distinguish the context in which this case was brought include: (1) the nature of the alleged conduct by the Fund’s investment adviser, officers and trustees as recited in the complaint (and summarized above); (2) the Fund being the only registered fund in its “complex” and in fact the only client of its investment adviser; and (3) the small size of the Fund (approximately \$2 million in assets under management).<sup>12</sup>

Nonetheless, this case is notable as the first enforcement action relating to the Liquidity Rule, and for the inclusion of charges against the Fund’s trustees, including its independent trustees. In that regard, it underscores the importance the Commission places on registrants’ timely compliance with recently adopted rules and illustrates that the Commission is willing, in the right circumstances, to bring an action against independent trustees. It also highlights the importance of the role of board oversight in light of recently adopted and proposed rulemaking by the Commission under the 1940 Act, which continues to increase the responsibilities placed on fund boards.

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## NOTES

- <sup>1</sup> See Complaint, SEC v. Pinnacle Advisors, LLC *et al.*, No. 5:23-cv-00547-FJS-ATB (N.D.N.Y. filed May 5, 2023), available at <https://www.sec.gov/litigation/complaints/2023/comp-pr2023-90.pdf>; see also SEC Charges Investment Adviser and Fund Trustees with Liquidity Rule Violations, SEC Press Release No. 2023-90 (May 5, 2023), available at <https://www.sec.gov/news/press-release/2023-90>.
- <sup>2</sup> See *Pinnacle*, *supra* n.1. An affiliate of the adviser settled separate charges for making false and misleading statements in its Form ADV brochure regarding reviews of advisory client accounts and failing to disclose certain conflicts of interest, adopt and implement related policies and procedures, and deliver to clients required information about advisory personnel. The order required the affiliate to pay disgorgement of \$83,462, prejudgment interest of \$11,874, and civil penalties of \$393,381. See *Pinnacle Investments, LLC*, Release Nos. 34-97448, IA-6302 (May 5, 2023), available at <https://www.sec.gov/litigation/admin/2023/34-97448.pdf>.
- <sup>3</sup> See *Joseph Masella*, Release Nos. IA-6303, IC-34908 (May 5, 2023), available at <https://www.sec.gov/litigation/admin/2023/ia-6303.pdf>. Without admitting or denying the SEC’s findings, the trustee consented to an order requiring him to cease and desist from violations of the Liquidity Rule and pay a civil penalty of \$20,000, and suspending him from association with any investment adviser, registered investment company, and others for six months.
- <sup>4</sup> The Commission adopted different compliance dates for certain aspects of the Liquidity Rule applicable to fund complexes with net assets of at least \$1 billion (December 1, 2018) and less than \$1 billion (June 1, 2019), the latter of which applied to the Fund.

<sup>5</sup> For purposes of an action brought by the Commission in a federal district court or other court pursuant to Sections 42(d) or 42(e) of the 1940 Act, Section 48(b) deems a person who knowingly or recklessly provides substantial assistance to another person in violation of a provision of the 1940 Act or the rules thereunder to be in violation of the same provision to the same extent as the person assisted. In light of the relatively small number of SEC enforcement actions brought in such courts involving the 1940 Act, the Commission has brought only a few actions pursuant to the authority conferred upon it by Section 48(b). *See, e.g.*, Complaint, SEC v. Charles Schwab Investment Management Inc. et al, No. 11-0136 (N.D. Ca. filed Jan. 11, 2011), available at <https://www.sec.gov/litigation/complaints/2011/comp21806.pdf>; Complaint, SEC v. David B. Welliver and Dblaine Capital, LLC, No. 0:11-cv-03076-RHK-SER (D. Minn. filed Oct. 18, 2011), available at <https://www.sec.gov/litigation/complaints/2011/comp22131.pdf>; Complaint, SEC v. James Velissaris, No. 1:22-cv-01346 (S.D.N.Y. filed Feb. 17, 2022), <https://www.sec.gov/files/litigation/complaints/2022/comp-pr2022-29.pdf>.

<sup>6</sup> On July 11, 2023, the adviser and its two officers filed a motion to dismiss the SEC's complaint on various grounds, including that the Commission lacked the authority to adopt the Liquidity Rule. *See* Motion to Dismiss, SEC v. Pinnacle Advisors, LLC et al., No. 5:23-cv-00547-FJS-ATB, Document 22-1 (N.D.N.Y. filed July 11, 2023). Simultaneously, the independent trustees filed a parallel motion to dismiss the Commission's complaint, also arguing that the Commission lacked the authority to adopt the Liquidity Rule. *See* Motion to Dismiss, SEC v. Pinnacle Advisors, LLC et al., No. 5:23-cv-00547-FJS-ATB, Document 25-1 (N.D.N.Y. filed July 11, 2023). The independent trustees additionally argue that the Commission fails to state a claim against the named independent trustees by failing to adequately plead the elements of aiding and abetting (substantial assistance, scienter and primary violation of the 1940 Act). Among other things, the independent trustees argue that (1) they did not substantially

assist, associate with, or participate in the liquidity classification of the Fund's assets; (2) they did not act knowingly or recklessly regarding the primary violation as they were unaware of a primary violation, complied with the standard of care required under the Liquidity Rule, and cannot be reckless with subjective determinations; and (3) there was no primary violation of the Liquidity Rule.

<sup>7</sup> *See Investment Company Liquidity Risk Management Programs*, Release Nos. 33-10233, IC-32315, 81 FR 82142, 82168 (Nov. 18, 2016) (Adopting Release), available at <https://www.federalregister.gov/documents/2016/11/18/2016-25348/investment-company-liquidity-risk-management-programs>.

<sup>8</sup> On November 2, 2022, the Commission proposed amendments to the Liquidity Rule. If the amendments are adopted as proposed, the "less liquid investment" classification would be eliminated. *See Proposed Rule: Open-End Fund Liquidity Risk Management Programs and Swing Pricing; Form N-PORT Reporting*, Release Nos. 33-11130, IC-34746, available at <https://www.sec.gov/rules/proposed/2022/33-11130.pdf>. For a discussion of the proposed amendments, please see the Willkie Farr & Gallagher LLP Client Alert, available at <https://www.willkie.com/-/media/files/publications/2022/secproposalamendmentstoliquidityriskmanagementprog.pdf>.

<sup>9</sup> *See* Adopting Release, *supra* n.7, at 82212 ("[T]he role of the board under the rule is one of general oversight, and consistent with that obligation we expect that directors will exercise their reasonable business judgment in overseeing the program on behalf of the fund's investors."), and at 82213 ("Given the board of directors' historical oversight role, the Commission continues to believe it is appropriate to require a fund's board to oversee the fund's liquidity risk management program. The Liquidity Rule's requirements are designed to facilitate the board's oversight of the adequacy and effectiveness of the fund's liquidity risk management program.").

<sup>10</sup> The LRMP administrator could be any of the fund's officers (other than solely portfolio managers), or the fund's investment adviser. *See* Rule 22e-4(a)(13).

<sup>11</sup> *Pinnacle*, *supra* n.1, at 3.

<sup>12</sup> Based on the allegations in the complaint, it appears that the Fund experienced at least one other significant compliance-related issue during the period

in question, namely, the loss of its regulated investment company tax status under Subchapter M of the Internal Revenue Code of 1986, as amended.

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