Katten Financial Markets and Funds *Quick Take*
February 2023

SEC Announces Inspection Priorities for 2023

By Richard Marshall

On February 7, the Securities and Exchange Commission (SEC) announced its inspection priorities for the current year. The announcement began by noting that the SEC examined 15 percent of the advisers during the last fiscal year and that "increased examinations can only be achieved with significant investments in human capital and technology resources."

Priorities for the current year include checking compliance with recently adopted rules, including the new marketing rule for advisers, the new derivatives rule for registered funds and Regulation Best Interest for broker-dealers.

For private funds, in addition to traditional focuses on conflicts and fees and expenses, the inspection program will examine uses of alternative data and personal devices by advisory personnel, the custody rule, and private funds with high risk characteristics, such as: "(1) highly-leveraged private funds; (2) private funds managed side-by-side with [business development companies] BDCs; (3) private equity funds that use affiliated companies and advisory personnel to provide services to their fund clients and underlying portfolio companies; (4) private funds that hold certain hard-to-value investments, such as crypto assets and real estate-connected investments, with an emphasis on commercial real estate; (5) private funds that invest in or sponsor Special Purpose Acquisition Companies (SPACs); and (6) private funds involved in adviser-led restructurings, including stapled secondary transactions and continuation funds."

When advisers offer environmental, social and governance- (ESG) related advisory services and fund offerings, the SEC will focus on "whether the funds are operating in the manner set forth in their disclosures." Cybersecurity also will be a significant priority in inspections of both advisers and broker-dealers, with a "focus on firms' policies and procedures, governance practices, and response to cyber-related incidents, including those related to ransomware attacks, and broker-dealers' and [registered investment advisers'] RIAs' compliance with Regulations S-P and S-ID, where applicable." Finally, issues relating to cryptocurrencies remain a high priority in the SEC's inspection program. *Read the SEC's press release.*

SEC Proposes Amendments to the Custody Rule

By Adam Bolter and Alexander Kim

On February 15, the SEC voted 4-1 to propose amendments to the Custody Rule under the Advisers Act (last amended in 2009 following the Bernard Madoff and Allen Stanford frauds). Over time, the current Custody Rule has presented challenges regarding, for example, when an adviser has "custody" under the rule, as well as the treatment of digital assets. While a number of current Custody Rule concepts remain familiar, proposed rule 223-1 (redesignated from rule 206(4)-2) would, among other things:

- expand the scope of the rule to cover any client assets over which an investment adviser has custody beyond "funds and securities" covered under the current rule. Importantly, this would bring into scope cryptoassets that might be argued not to be funds or securities (as well as other assets such as real estate, loans, and derivatives). The SEC implies, however, in its proposing release, that most cryptoassets are today likely covered by the Custody Rule as either funds or securities;
- make explicit that discretionary trading authority would trigger application of the rule. Notably, the proposed rule would provide a limited exception to the surprise examination requirement with regard to client assets maintained with a qualified custodian when the sole basis for application of the rule is an adviser's discretionary authority that is limited to instructing the client's custodian to transact in assets that settle only on a delivery versus payment basis;
- require that advisers enter into written agreements with and obtain reasonable assurances from qualified custodians to ensure that clients receive standard custodial protections and impose additional requirements on entities who serve as qualified custodians for purposes of the rule;
- expand the current Custody Rule's audit provision as a means of satisfying the surprise examination requirement;
- modify the current rule's privately offered securities exception from the obligation to maintain assets with a qualified custodian by refining the definition of "privately offered securities," expanding the exception to include certain physical assets, and requiring advisers to take additional steps to safeguard these assets; and
- amend reporting obligations on Form ADV and require corresponding amendments to the books and records provisions. *Read about the SEC's proposal.*

SEC Delays Enforcement of Rule 15c2-11 Compliance

By Chris DiAngelo, Anna-Liza Harris, Howard Schickler, Prachi Gokhale and Dylan Caffrey

In 2021, the Securities and Exchange Commission (SEC) took the industry off-guard by announcing its new position that Rule 15c2-11 of the Securities Exchange Act of 1934 (Rule) and its amendments apply to fixed-income securities, which had previously not been subject to enforcement actions under the Rule. The amendments to the Rule in September 2020, from which this interpretation arose, requires brokers and dealers in deriving their quotes to be published in a quotation medium to review documents that are "current" and "publicly available." On November 30, 2022, the SEC issued a No-Action Letter delaying full compliance with these requirements of the amendments to the Rule from January 3, 2023 to January 4, 2025. *Read Katten's advisory.*

Half of all States Sue DOL Over ESG Rule, Foreshadowing Challenges to the SEC's ESG Agenda

By Danette Edwards, Johnjerica Hodge and Ifedapo Benjamin

On January 26, 25 states, plus a publicly traded energy company with a subsidiary that is a fiduciary and trustee under ERISA, a trade association for the oil and gas industry, and a participant in an ERISA plan sued the US Department of Labor (DOL) and its Secretary in connection with DOL's recent ESG rulemaking. *Utah v. Walsh, N.D. Tex., No. 2:23-cv-0016-Z.* The suit asserts claims under the Administrative Procedure Act stemming from alleged ERISA violations as well as an argument that DOL's new ESG rule is arbitrary and capricious.
The lawsuit is part of a movement in some areas of the country that seeks to restrict certain ESG activities. Some of the plaintiff states in the lawsuit have adopted "anti-ESG" laws or policies

seeking, for example, to protect particular industries (e.g., fossil fuels and firearms) by targeting ESG-based investing and ESG sustainability ratings. *Read more about the SEC's ESG agenda.*

Delaware Court of Chancery Ruling Imposes a Fiduciary Duty of Oversight on Corporate Officers

By Sarah Eichenberger, Jonathan Rotenberg and Danette Edwards

On January 26, 2023, the Delaware Court of Chancery resolved a long-standing ambiguity in Delaware law, clarifying, for the first time, that corporate officers owe a fiduciary duty of oversight. The case, *In re McDonald's Corporation Stockholder Derivative Litigation*, No. 2021-0324, 2023 WL 387292 (Del. Ch. Jan. 26, 2023), involved derivative claims by McDonald's stockholders against the company's board of directors and certain officers, including the former Chief People Officer. Vice Chancellor Laster, dealing solely with the former Chief People Officer's motion to dismiss, held that the complaint sufficiently alleged that the former executive: (i) consciously ignored red flags concerning sexual harassment; and (ii) engaged in sexual harassment. This decision has significant implications for derivative lawsuits concerning ESG issues and corporate crises alike. *Read about the court's decision on oversight duties.*

Illinois' Highest Court Holds That BIPA Claims are Subject to a Five-Year Statute of Limitations, Not One Year

By Janet Widmaier, Geoffrey Young and Charles DeVore

In a significant shift in law, the Illinois Supreme Court recently held that all claims under the Biometric Information Privacy Act (BIPA) are subject to a five-year statute of limitations. This reverses prior case law that required certain BIPA claims to be asserted within one year of the alleged violations. This change in law substantially increases potential liability for employers and businesses operating in Illinois. *Read about how this impacts Illinois employers.*

Whistleblower Complaint Capitalizes on SEC Interest in Sustainability Fraud

By Danette Edwards and Chris Cole

Multiple news outlets recently reported that the activist group Mighty Earth filed a whistleblower tip, which it styled as an informal complaint, urging the SEC to investigate whether a multinational food company (the "offeror") fraudulently misled investors in connection with multiple offerings of more than $3 billion worth of so-called "green bonds." The SEC investigates whistleblower tips privately, and thus the public usually never hears about them. Mighty Earth described the complaint on its website, however, making it one of the first "greenwashing" complaints known to have been lodged with the SEC. Mighty Earth appears to dispute the veracity of statements calling at least one of the issuances "sustainability-linked" and "aligned" with the offeror's "ambition to achieve net-zero greenhouse gas emissions by 2040 and its commitment to reduce greenhouse gas emissions in its operations by 30% by 2030." *Read about the SEC's Climate and ESG Task Force.*

But Is It Art? New York Jury Says No - It's Trademark Infringement in the Metaverse

By Cynthia Martens and Karen Artz Ash

To quote a headline from French daily Libération, "Hermès 1, NFT 0." On February 8, a federal jury in New York sided with France's storied luxury fashion company, Hermès International S.A., in a trademark battle against LA-based digital artist Mason Rothschild. The closely-watched case was expected to be a bellwether for the strength of traditional trademark and trade dress rights in the realm of crypto assets and virtual fashion. Tellingly, trademark rights prevailed. *Read about this NFT trademark case.*

January 31 was the Deadline to Register as an Overseas Entity in the UK

By Edward Tran, Oliver Williams, Gavin Vollans and Omar Malek

January 31 was the deadline for registration as an Overseas Entity. All qualifying overseas entities, who own freehold land or property in the UK (or leasehold land of more than seven years), must have registered as such with Companies House. The Register of Overseas Entities, which went into effect on August 1, 2022, under the Economic Crime (Transparency and Enforcement) Act 2022, requires qualifying overseas entities to identify and verify their beneficial owners or managing officers (using an independent verification process), and submit the information to Companies House. *Read Katten's advisory.*

EU-US Transborder Data Flows to be Reviewed by the European Data Protection Board

By Trisha Sircar

On December 13, 2022, the European Commission published its draft adequacy decision recognizing the essential equivalence of US data protection standards, laying the foundations for finalization of the European Union (EU)-U.S. Data Privacy Framework and unhampered cross-border data flows between the EU and the United States. *Read about cross-border personal data transfer issues.*

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