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Regulatory Recap

March 28, 2024

Notable Developments:

- **SEC adopted amendments to internet adviser exemption.**
- **SEC published two FICC's rule filings regarding facilitating access to clearing, account types and account segregation.**
- **Fund industry groups challenged SEC's newly-adopted dealer registration rule.**

SEC Enforcement

- **Genesis settled SEC charges regarding the allegation of its unregistered offer and sale of securities through Gemini Earn program.**
- **Delphia and Global Predictions consented to orders of violating the Advisers Act for making false and misleading statements concerning the use of AI and machine learning.**

In Case You Missed It

- **SEC's Division of Examination published Risk Alert on the shortening of the settlement cycle to T+1.**
- **FINRA published advance notice of upcoming enhancements to equity trade reporting for fractional share transactions.**
- **FINRA announced amendments to margin requirements related to protected option or warrant positions under FINRA Rule 4210.**
- **SEC seeks to impose $1.95 billion in penalties in final judgment against Ripple.**

Notable Developments:

SEC adopted amendments to internet adviser exemption.

On March 27, 2024, the SEC adopted final rule amendments to the rules that permit internet investment advisers to register with the SEC ("internet adviser exemption"). The final rules remove the de minimis exception from the internet adviser exemption, which currently permits internet advisers to have fewer than 15 non-internet clients in the preceding 12-month period. Under the new rules, investment advisers who wish to rely on the internet adviser exemption to register with the SEC will be required to provide investment advisory services to all clients exclusively through an operational interactive website at all times. The final rules also amend Form ADV to include a separate text description of the actions an internet investment adviser must have taken to become or remain eligible for the internet adviser exemption at the time of filing Form ADV. Such text description will clearly state the requirements that an internet adviser must meet in order to qualify for the internet adviser exemption and the internet adviser must certify that it has met such requirements when it files Form ADV.

The final rules will become effective 90 days after the publication in the Federal Register. The compliance date will be March 31, 2025. An adviser who wishes to rely on the internet adviser exemption to register

or to maintain registration with the SEC must meet all the conditions in the final rules by March 31, 2025. If an investment adviser is no longer eligible to rely on the amended internet adviser exemption by March 31, 2025, it must determine whether it must register in one or more states and withdraw its registration with the SEC by filing a Form ADV-W by June 29, 2025. After June 29, 2025, the SEC expects to cancel registration of advisers who are no longer eligible to register with the SEC that fail to withdraw their registrations.

SEC published two FICC's rule filings regarding facilitating access to clearing, account types and account segregation.

The SEC accepted FICC's rule filings and published notice of FICC's proposed rule change SR-FICC-2024-005 regarding FICC's clearing access models on March 21, 2024 and notice of FICC's proposed rule change SR-FICC-2024-007 regarding account types, segregation and calculation, collection and holding of margin on March 22, 2024. These rule filings are critical to the implementation of the SEC final rules that mandate clearing of eligible secondary Treasury securities transactions published in December 2023. We provide more details below regarding how FICC proposes to facilitate access to its clearing services by indirect participants and how it proposes to segregate, collect, hold and calculate customer margin.

Fund industry groups challenged SEC's newly-adopted dealer registration rule. The National Association of Private Fund Managers (NAPFM), Managed Fund Association (MFA) and the Alternative Investment Management Association (AIMA) filed a lawsuit against the SEC in the U.S. District Court for the Northern District of Texas seeking to vacate the recent rule amendments adopted by the SEC on February 6, 2024 to the definition of "dealer" and "government securities dealer" in the Securities Exchange Act ("dealer registration rule"). The petition alleges that the dealer registration exceeds the SEC's statutory authority, is arbitrary and capricious in violation of the Administrative Procedures Act and is otherwise unlawful because it imposes a burden on competition not necessary or appropriate in furtherance of the purposes of the Securities Exchange Act. The same trade groups have also sued the SEC over new rules that require reporting and public disclosure of securities lending and short-selling activity adopted by the SEC on October 12, 2023. NAPFM, MFA, AIMA, together with American Investment Council, Loan Syndication & Trading Association, and National Venture Capital Association also filed suit to challenge the new private fund adviser rules adopted by the SEC on August 23, 2023.

Enforcement Actions:

- **Genesis settled SEC charges regarding the allegation of its unregistered offer and sale of securities through Gemini Earn program.** On March 19, 2024, the SEC announced settled charges against Genesis Global Capital, LLC ("Genesis") regarding the SEC's allegation that the Genesis Earn program, a crypto asset lending program, constituted an unregistered offer and sale of securities. The SEC charged Genesis and Gemini Trust Company, LLC ("Gemini") on January 12, 2023 and filed a complaint against Genesis and Gemini in the U.S. District Court, Southern District of New York. The complaint alleged that the Gemini Earn program was a purported investment opportunity where Gemini customers loaned their crypto assets to Genesis in exchange for Genesis' promise to pay interest earned from Genesis' use of the loaned crypto assets. Genesis and two affiliates filed Chapter 11 bankruptcy on January 19, 2023 and investors have been unable to access or withdraw the crypto assets they invested with Genesis via Gemini Earn. Under the settlement

terms, the SEC will receive a $21 million civil penalty amount after payment of all other allowed claims by the bankruptcy court, including claims by retail investors in the Gemini Earn program.

- **Delphia and Global Predictions consented to orders of violating the Advisers Act for making false and misleading statements concerning the use of AI and machine learning.** On March 18, 2024, the SEC announced settled charges against Delphia (USA) Inc. and Global Predictions Inc. in two separate actions for misleading statements about their use of AI. Delphia was charged, among others, with disseminating advertisements that included untrue statements of its use of AI. According to the SEC's order, Delphia claimed that it "put 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"; however, the SEC order found that these statements were false and misleading because Delphia did not in fact have the AI and machine learning capabilities that it claimed.

  Separately, the SEC found that Global Predictions Inc. made false and misleading claims on its website and on social media advertising as being "first regulated AI financial advisor" and that its platform provided "[e]xpert AI-driven forecasts." The SEC order also alleged that Global Predictions violated the Marketing Rule, falsely claiming that it offered tax-loss harvesting services and included an impermissible liability hedge clause in its advisory contract.

  In a statement, SEC Chair Gensler stated "[w]e'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."

In Case You Missed It…

- **SEC's Division of Examination published Risk Alert on the shortening of the settlement cycle to T+1.** On March 27, 2024, the SEC's Division of Examination published a Risk Alert on the shortening of the settlement cycle of securities transactions from T+2 to T+1 for most broker-dealer transactions on May 28, 2024, which is also the compliance date for new amendment to Rule 15c6-1 and new Rule 15c6-2, Rule 17Ad-27, and Rule 204-2 related to the processing of institutional trades by broker-dealers and clearing agencies, as well as certain recordkeeping amendments applicable to registered investment advisers. The Division of Examination reminds registrants and market participants of the importance of being prepared for the change of the shortened settlement cycle in order to manage the transition. The Risk Alert provides additional information about the scope and content of the examinations and outreach.

- **FINRA published advance notice of upcoming enhancements to equity trade reporting for fractional share transactions.** On March 22, 2024, FINRA published an advance notice of futures updates to is equity trade reporting guidance in connection with upcoming enhancements to FINRA's equity trade reporting facilities to support reporting of fractional share quantities. The updated guidance will require Members engaged in fractional share trading to report fractional

share quantities up to six digits after the decimal with the effective date no earlier than the first quarter of 2025.

- **FINRA announced amendments to margin requirements related to protected option or warrant positions under FINRA Rule 4210.** On March 19, 2024, FINRA published Regulatory Notice 24-08 to announce amendments to FINRA Rule 4210 (Margin Requirements) to include an exception with respect to "protected" option or warrant positions that conforms with similar provisions Cboe recently adopted. The amendments are effective as of March 19, 2024. "Protected" option or warrant positions are short option or warrant positions on indexes that are written against products that track the same underlying index. Such short option or warrant positions on indexes are offset by positions in an underlying stock basket, non-leveraged index mutual fund or non-leveraged ETS that is based on the same index option. The exception provided in the amendment does not apply to leveraged instruments.

- **SEC seeks to impose $1.95 billion in penalties in final judgment against Ripple.** On March 22, 2024, SEC filed a motion for remedies and entry of final judgment as to Ripple Labs, Inc. to seek a court order imposing permanent injunction, disgorgement, interest and civil penalties in the aggregate of $1,950,768,364 in final judgment against Ripple Labs.

FICC's Latest Rule Filings to Implement Mandatory Clearing of Eligible Secondary Treasury Securities Transactions

The SEC published notice of FICC's proposed rule change SR-FICC-2024-005 regarding FICC's clearing access models on March 21, 2024 and notice of FICC's proposed rule change SR-FICC-2024-007 regarding account types, segregation and calculation, collection and holding of margin on March 22, 2024. These rule filings are critical to the implementation of the final rules that mandate clearing of eligible secondary Treasury securities transactions adopted by the SEC in December 2023. We provide a few important details below regarding these rule filings.

1. SR-FICC-2024-005

In the SR-FICC-2024-005 filing, FICC proposes to:

- rename the current correspondent/prime broker clearing model to agent clearing model, recognizing the similarities between the correspondent/prime broker clearing model and the agent clearing model in the cleared derivatives markets, through which indirect participants may execute commodity derivatives with third parties and then give them up to their FCM for clearing. FICC believes that such change would allow netting members and their customers to identify the agent clearing services at FICC as a workable "done away" solution. The change of the name of Correspondent/prime broker clearing model to Agent Clearing model does not change the netting member's (or agent clearing member's) obligations. The netting member/agent clearing member remains the one that has contractual relationship with FICC and is responsible for posting margin with respect to its prop accounts and indirect participants' account(s). FICC also clarifies that,

between the agent clearing member and an executing firm customer, FICC only requires a written agreement in place to bind the latter to the applicable provisions of the FICC rules. Beyond this specific requirement, the FICC's proposed rule changes explicitly acknowledge that such written agreement may otherwise be on any terms and conditions mutually agreed to by the agent clearing member and the executing firm customer. FICC's rules do not prohibit any reimbursement or other payments sharing arrangements that may be established between the parties, away from FICC. The name change from the existing correspondent/prime broker clearing model to agent clearing model must be understood in conjunction with the new account types and segregation rule change (discussed below) in order to fully appreciate how FICC's new agent clearing model will work.

- remove the category 1 sponsoring members from its rules and, instead, apply the activity limit currently applicable to category 2 sponsoring members to all sponsoring members. The proposed rule change also removes the QIB requirement applicable to sponsored members.
- Provide a road map of access models to allow both buy- and sell sides to understand FICC's clearing models and to consider how to offer and price these models to ensure indirect participants can access central clearing.

2. SR-FICC-2024-007

In the SR-FICC-2024-007 filing, FICC proposes to:

- separate and segregate indirect participants' margin from the netting member's margin by proposing separate account types for the separate and independent calculation, collection and holding of (i) margin deposited by a netting member for its proprietary positions and (ii) margin deposited by a netting member for the transaction of an indirect participant.
- allow for the segregation of indirect participants' margin in a manner that satisfies the conditions for a broker-dealer to record a debit in the customer or PAB reserve formula under the recently added Note H to Rule 15c3-3a. Under the proposed rule change, a netting member (regardless of whether such netting member is a broker-dealer) may elect to designate any of its indirect participants' omnibus accounts for segregation. If an indirect participants' omnibus accounts are designated to be segregated, FICC:
    - (i) would calculate a netting member's segregated customer margin requirement on a segregated-indirect-participant-by-segregated-indirect participant basis;
    - (ii) would not net the transactions of one indirect participant against the transactions of another indirect participant;
    - (iii) would only be able to use the segregated margin to satisfy the obligations of the indirect participant for whom such margin is held and would not apply such margin to the proprietary obligations of the netting member or to the obligations of any other netting member or participant. Segregated customer margin would not form part of the clearing fund and FICC's ability to use clearing fund would not apply to segregated customer margin;

(iv) would require that the segregated margin requirement be no lower than $1 million per segregated indirect participant, and that no less than $1 million per segregated indirect participant consist of cash;

(v) would hold all segregated customer margin in an account of FICC at a bank that is insured by FDIC or at the Federal Reserve Bank of New York; such account would be segregated from any other account of FICC and would be used exclusively to hold segregated customer margin in accordance with section (b)(2)(iv)(A) of Note H to Rule 15c3-3a;

(vi) would only hold segregated customer margin consisting of cash in a cash deposit account at the FRB New York or another FDIC-insured bank and does not intend to make any other investment of such cash.

- calculate a segregated indirect participant's margin twice each business day and allow a netting member to obtain the return of excess segregated margin of an indirect participant, subject to FICC's discretion not to release excess margin if the netting member has any outstanding payment or margin obligation with respect to the transactions of any segregated indirect participant.
- align margin methodology with the new account types through several changes:

(i) FICC would limit margin portfolios to accounts of the same type and make it clear that a netting member's margin requirement is the sum of the margin amounts calculated for each type of account in which transactions are recorded for the netting member; transactions recorded in different types of accounts could not be netted against each other when calculating a netting member's margin or an indirect participant's segregated customer margin.

(ii) The margin component schedule for the margin methodology calculation would be substantively the same as the existing schedule except that certain margin components would be adjusted for purposes of segregated customer margin requirements in order to calculate margin charges on a segregated indirect participant-by-segregated indirect participant basis. In addition, the MLA Charge definition would be amended to provide that, if a segregated indirect participant clears through multiple accounts (including accounts of different netting members), then the MLA Charge applicable to such segregated indirect participant's transactions would equal the greater of (i) an amount calculated only with regard to the transactions maintained in that account (without regard to the other accounts in which the segregated indirect participant's transactions are recorded) and (ii) an amount calculated on a consolidated portfolio basis (i.e., taking into account the transactions carried in each of the accounts), which is currently the same methodology used for sponsored members that clear through multiple accounts.

(iii) FICC would establish the method for allocating net unsettled positions to individual indirect participants for purposes of calculating margin requirements; net unsettled positions in a sponsoring member omnibus account or segregated indirect participants account that are not clearly allocable to an individual sponsored member or segregated indirect participant would be allocated, for purposes of calculating

margin requirements, pro rata to the sponsored members or segregated indirect participants that had, as of the end of the preceding business day, positions in the same direction and CUSIP as the un-allocable "current net unsettled positions." This could happen if, for example, a transaction recorded in a sponsoring member omnibus account or segregated indirect participants' account fails to settle.

(iv) Establishing separate deposit ID to ensure collection and holding of margin for proprietary transactions separately and independently of margin for indirect participant transactions.

(v) Revising and clarifying the calculation of the excess capital premium component of the clearing fund to cap the excess capital premium amount at two times the amount by which a netting member's VaR charge exceeds its netting member capital and limiting FICC's discretion to waive the excess capital premium amount. FICC further proposes to exclude VaR charge calculated with respect to segregated indirect participants from the excess capital premium calculation. The VaR charge assessed for each segregated indirect participant would be satisfied by the segregated indirect participant, and not by the netting member.

(vi) Narrowing the concept of brokered transactions to the effect that only transactions that an inter-dealer broker netting member executes on the inter-dealer netting member's own trading platform may benefit from favorable $5 million loss allocation cap treatment.

FICC expects to implement the proposed rule change by March 31, 2025, subject to the completion of all regulatory actions and receipt of the required regulatory approval.