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SEC Brings First Liquidity Rule Enforcement Action Against Investment Adviser and Fund Board

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On May 5, 2023, the Securities and Exchange Commission ("SEC") filed charges against Pinnacle Advisors LLC ("Pinnacle Advisers"), an investment adviser, for allegedly aiding and abetting violations of Rule 22e-4 (the "Liquidity Rule") under the Investment Company Act of 1940, as amended (the "1940 Act"), by a mutual fund it advised and whose liquidity risk management program ("LRMP") it administered. More significantly, the SEC also charged the fund's two independent trustees, Mark Wadach and Lawton "Charlie" Williamson, as well as two officers of both Pinnacle Advisors and the fund, Robert Cuculich and Benjamin Quilty, for allegedly aiding and abetting the fund's violations. A former interested trustee, Joseph Masella, agreed to pay a civil penalty of $20,000 to settle charges related to the fund's violations and to cease and desist from violations of the Liquidity Rule.

This case marks the first enforcement action enforcing the Liquidity Rule, which prohibits mutual funds from investing more than 15% of their net assets in illiquid investments. The rule also requires funds to take prompt, corrective measures if they exceed this limit and to have an LRMP in place to assess their liquidity risk. The case also highlights an unusual move by the SEC of charging the independent directors under Section 48(b) of the 1940 Act, which states that a person who knowingly or recklessly provides substantial assistance to another person in the course of a violation is equally in violation of the same provision.

Background

Under the Liquidity Rule, open-end funds, including exchange-traded funds, are required to classify the liquidity of a fund's portfolio investments into one of four categories: highly liquid, moderately liquid, less liquid and illiquid. Open-end funds are also required to conduct at least monthly reviews of these classifications.

According to the SEC's complaint, between June 2019 and June 2020, the fund held over 21% of its net assets in holdings that it classified as "illiquid investments." Instead of reducing its illiquid investments to comply with the 15% limit under the Liquidity Rule, Pinnacle Advisors and its officers allegedly reclassified the fund's illiquid investments as "less liquid investments," disregarding contractual and legal restrictions on the sale and transfer of the securities, the absence of a market for the shares, and advice from fund counsel and auditors that the holdings were illiquid. The adviser and its officers also allegedly failed to make requisite reports to the fund's board and related filings with the SEC in accordance with the Liquidity Rule.

The complaint also accuses Cuculich, Quilty, and Masella of misleading the SEC's Division of Investment Management regarding the basis for the fund's liquidity classifications. The fund's board, including Wadach and Williamson, who were aware of the restricted and illiquid nature of the shares, allegedly failed to exercise reasonable oversight of the fund's LRMP, thus aiding and abetting the fund's violation.

The SEC's complaint sought permanent injunctions and civil money penalties. The fund is now a liquidating trust and is not being separately charged. In a statement in connection with the case, SEC staff stated that trustees must fulfill their oversight responsibilities to protect shareholder interests and noted that trustees will be held accountable "when they fail to fulfill the most basic requirements under the applicable rules."

Key Takeaway

- Due to the uniquely unflattering facts in this case, it is difficult to take it as an indication that increased SEC enforcement actions against fund boards and independent board members arising specifically from the Liquidity Rule will be forthcoming. However, this case does underscore the importance of funds and their boards complying in a timely way with recently adopted rules — including the Liquidity Rule — and shows the SEC's willingness to bring enforcement actions against independent board members when the message value is high.

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