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Investment Management Update

October 2024

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In This Update

Covering legal developments and regulatory news for funds, their advisers, and industry participants for the quarter ended June 30.

Rulemaking and Guidance

SEC Issues Third Marketing Rule Risk Alert for Investment Advisers

05.09.24

On April 17, the U.S. Securities and Exchange Commission's (SEC) Division of Examinations (EXAMS) issued its third risk alert on the amended Rule 206(4)-1 (the Marketing Rule) under the Investment Advisers Act of 1940 (Advisers Act). EXAMS issued its first risk alert on the Marketing Rule ahead of its November 2022 required compliance date, outlining the aspects it expected to focus on during its initial exam phase. About seven months after the rule's required compliance date, EXAMS issued a second risk alert, detailing its next exam phase, including its increased focus on additional Marketing Rule-related aspects. The third alert includes EXAMS' preliminary observations of its Marketing Rule exams, aiming to promote accurate completion of Marketing Rule items in Form ADV, compliance with Advisers Act Rule 204-2 Books and Records rule, and adherence to the general prohibitions set forth in Rule 206(4)-1(a). A summary of EXAMS' observations is set forth below:

Observations on Compliance, Books and Records Rule, and Form ADV

Advisers Act Rule 206(4)-7 Compliance Rule: Advisers have generally incorporated Marketing Rule processes into their compliance policies and procedures, with many requiring pre-approval of advertisements. However, some policies were found to be inadequately designed or implemented, leading to potential violations. Common issues identified include policies only containing general descriptions and expectations related to the Marketing Rule, informal policies that were not in writing, and policies that were updated but not implemented.

Advisers Act Rule 204-2 Books and Records Rule: Advisers have updated their policies to include Marketing Rule-related books and records requirements. Despite these updates, deficiencies were noted, such as failures to maintain necessary documentation to support performance claims and copies of questionnaires or surveys used in third-party ratings.

Form ADV: Many advisers had updated their Form ADVs to include advertising-related disclosures. Nevertheless, inaccuracies were detected, including incorrect reporting on advertisements that featured third-party ratings, performance results, or hypothetical performance. Additionally, some advisers had not updated outdated references to Advisers Act Rule 206(4)-3), the prior Cash Solicitation Rule. Some indicated that no referral arrangements existed, or

otherwise omitted material terms and compensation details of referral arrangements on Form ADV, Part 2A, Item 14.

Compliance With the Marketing Rule's General Prohibitions

EXAM's review identified several deficiencies in compliance with the Marketing Rule's General Prohibitions, including:

Untrue or Unsubstantiated Statements of Material Facts: Some advertisements contained material statements that were either untrue or could not be substantiated upon demand, such as the assertion that advisers were "free of all conflicts," when actual conflicts existed, and erroneous representations regarding adviser personnel education, experience, and professional designations. EXAMS also cited references to environmental, social, and governance (ESG) investment mandates where no such mandates were actually used. The risk alert serves as a reminder that if an adviser is unable to substantiate the material claims of fact made in an advertisement upon demand, EXAMS will presume that the adviser did not have a reasonable basis for its belief.

Omission of Material Facts or Misleading Inference: Advertisements occasionally omitted necessary material facts or presented information that could lead to misleading implications about the adviser. Such advertisements included statements, such as the adviser being different than others because it acts in the "best interest of clients" (without disclosing that all advisers have a fiduciary duty), or that the adviser was "seen on" national media (implying an appearance rather than a paid advertisement). Other violative statements included misleading third-party ratings and testimonials. Notably, the risk alert also highlighted several misleading performance advertisements, such as those that:

- Did not provide adequate disclosure regarding the share classes included in the performance returns.
- Used lower fees in calculations for net of fees performance returns than those offered to the intended audience.
- Omitted material information regarding fees and expenses used in calculating returns.
- Included index benchmark comparisons without defining the index or providing sufficient context to enable an understanding of the basis for such comparison, or failing to disclose that the benchmark performance did not include the reinvestment of dividends.
- Contained outdated market data information only (*e.g.*, market data from more than five years prior).
- Contained investment products that were no longer available to clients and included lower investment costs than were available.
- Presented advisers' performance track record with securities that were not purchased by the advisers in a similar manner in their clients' accounts.
- Included claims that the advisers achieved above average performance results without clarifying that the advisers did not yet have clients or performance track records.
- Included investment recommendations containing performance information that did not include disclosures to provide context to the presentations, such as advertising performance during

time periods when most investors would have experienced the advertised performance returns because of general market performance.

Fair and Balanced Treatment of Material Risks or Limitations: Some advertisements included statements about potential benefits of advisers' services without providing a fair and balanced treatment of the material risks or limitations associated therewith.

Inclusion or Exclusion of Performance Results or Time Periods in Manners That Were Not Fair and Balanced. Some advertisements did not disclose the time period, or whether the returns were calculated for the same time period as additional performance information included in the same advertisement. Some advertisements also included or excluded certain performance results in manners that were not fair and balanced, (*e.g.*, they included the performance of only realized investments in the total net return figure and excluded unrealized investments).

References to Specific Investment Advice: Certain advertisements did not present specific investment advice in a fair and balanced manner. For example, they excluded certain investments without providing sufficient information and context to evaluate the rationale (*e.g.*, investments were written off). Some advisers also did not have established criteria in their policies and procedures to ensure that references to specific investment advice were provided in a fair and balanced manner.[1]

Materially Misleading Advertisements: Some advertisements were found to present disclosures in unreadable font on websites or in videos.

A copy of EXAMS' alert is available at https://www.sec.gov/exams/announcement/risk-alert-041724.

Marketing Rule Enforcement Actions

In September 2023, the SEC announced its first set of Marketing Rule cases resulting from its ongoing sweep concerning Marketing Rule violations. Nine firms were charged in that first round, each on the basis that they advertised hypothetical performance to mass audiences on their websites without having the required policies and procedures. Two of the charged advisers also failed to maintain required copies of their advertisements.

On March 18, the SEC settled with two SEC registered investment advisers over statements about their use of artificial intelligence (AI). Although these cases received attention as the first of the SEC's AI enforcement efforts, the charges were related to the Marketing Rule's general prohibitions.

On April 12, the SEC announced its settlement with five SEC-registered investment advisers for Marketing Rule violations. All five firms had advertised hypothetical performance to the general public on their websites without adopting and implementing policies and procedures reasonably designed to ensure that the hypothetical performance was relevant to the likely financial situation and investment objectives of each advertisement's intended audience. One of the advisers was found to have violated additional regulatory requirements, including advertising misleading model performance, failing to substantiate advertised performance, and committing recordkeeping and compliance violations. That adviser also failed to enter into written agreements with people it compensated for endorsements.

Next Steps

Advisers are advised to thoroughly review and update, as needed, their marketing practices, Form ADV disclosures, and policies and procedures related to the Marketing Rule and Books and Records Rule, in light of EXAMS' observations.

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[1] On February 6, the SEC's Division of Investment Management issued a response to its Marketing Compliance FAQs regarding the calculation of net and gross performance of portfolios utilizing subscription lines of credit. The staff stated an adviser would violate Rule 206(4)-1(a)(1) and Rule 206(4)-1(a)(6)) if it showed only net IRR that includes the impact of fund-level subscription facilities without including either (i) comparable performance (*e.g.*, net IRR without the impact of fund-level subscription facilities) or (ii) appropriate disclosures describing the impact of such subscription facilities on the net performance shown. See SEC.gov | Marketing Compliance Frequently Asked Questions.

SEC Adopts Rule Amendments to Regulation S-P to Enhance Protection of Customer Information

05.15.24

On May 15, 2024, the SEC adopted amendments to Regulation S-P, which is the regulation that governs the treatment of nonpublic personal information about consumers maintained by certain financial institutions. The SEC originally proposed the amendments on March 15, 2023.

Goals of the Amendments

The amendments apply to broker-dealers (including funding portals), investment companies, registered investment advisers, and transfer agents (collectively, covered institutions). The amendments are intended to enhance the protection of consumer financial information by:

- Requiring covered institutions to develop, implement, and maintain written policies and procedures for incident response programs. These response programs should be reasonably designed to detect, respond to, and recover from unauthorized access to or use of customer information.
- Requiring that these response programs include procedures for covered institutions to provide timely notification to affected individuals whose sensitive customer information was, or is reasonably likely to have been, accessed or used without authorization.
- Broadening the scope of nonpublic information covered by Regulation S-P's requirements.

Overview of the Need for the Regulation S-P Amendments

In 2000, the SEC adopted Regulation S-P, which included the following:

- Safeguards Rule: Required that broker-dealers, investment companies, and registered investment advisers adopt written policies and procedures to safeguard customer records and information.
- Disposal Rule: Required proper disposal of consumer report information in a way that protects against unauthorized access to or use of such information.
- FAST Act: Implemented privacy policy notice and opt out provisions, which Congress later amended in the 2015 Fixing America’s Surface Transportation Act, which is known as the FAST Act.
- Application to Funding Portals: Under Regulation Crowdfunding, funding portals must also comply with the requirements of Regulation S-P as they apply to brokers.

More than 20 years have passed since the SEC initially adopted Regulation S-P. During these 20 years, there have been many technological developments, which in turn have impacted how covered institutions obtain, share, and maintain individuals’ personal information. These developments, however, have resulted in increased risk of harm to individuals’ personal information. As a result, the SEC believed it was necessary to adopt these amendments to modernize and improve Regulation S-P's requirements.

Further, the protections that covered institutions provide to their customers may vary across different states, so these final amendments establish a federal minimum standard for covered institutions to provide data breach notifications to impacted individuals.

Application of the Regulation S-P Amendments

Incident Response Program

The amendments require covered institutions to adopt an incident response program as part of their written policies and procedures to protect against harms that may result from a security incident related to customer information. Specifically, the amendments require that the incident response program include procedures to evaluate the nature and scope of any such incident and to then take appropriate steps to contain and control such incidents, preventing further unauthorized access or use. The incident response program should also include the establishment, maintenance, and enforcement of written policies and procedures reasonably designed to require oversight of service providers, including through due diligence and monitoring.

Customer Notification Requirement

The amendments require covered institutions to notify impacted individuals whose sensitive customer information was, or is reasonably likely to have been, accessed or used without authorization. Covered institutions need to provide notices as soon as practicable, but no later than 30 days after they become aware that unauthorized access to or use of customer information has occurred, or is reasonably likely to have occurred, except for in certain limited circumstances.

These notices must include details about the incident, the breached data, and how affected individuals can respond to the breach to protect themselves. It is important to note though that covered institutions are not required to provide these notices if they determine that the sensitive customer information has not been, and is not reasonably likely to be, used in a manner that would result in substantial harm or inconvenience to the affected individuals.

Additional Requirements of the Amendments

The amendments to Regulation S-P also requires covered institutions to:

- Expand and align the safeguards and disposal rules to cover both nonpublic personal information that covered institutions collect about their own customers along with nonpublic personal information they receive from other financial institutions about customers of that particular financial institution.
- Make and maintain written records documenting compliance with the requirements of the safeguards rule and disposal rule. This requirement does not apply to funding portals.
- Conform the exception added by the FAST Act to Regulation S-P's annual privacy notice delivery provisions, which provides that covered institutions are not required to deliver an annual privacy notice if certain conditions are met.
- Extend both the safeguards rule and the disposal rule to transfer agents registered with the SEC or another appropriate regulatory agency.

Next Steps in Implementation of the Amendments

The Amendments to Regulation S-P became effective August 2, 2024. Larger entities will have 18 months (or until December 3, 2025) to comply with the amendments, while smaller entities will have 24 months (or until June 3, 2026) to comply with the amendments.

A copy of the final rule can be found at: https://www.sec.gov/files/rules/final/2024/34-100155a.pdf.

The US Securities Market Will Transition to a T+1 Standard Settlement Cycle on May 28

05.21.24

SEC Chair Gary Gensler announced that the U.S. Securities Market will transition to a T+1 standard settlement cycle effective on May 28, 2024. This change means that investors who sell their stock will receive their money the next day, reducing risk and improving market efficiency.

On February 15, 2023, the SEC adopted rule amendments to shorten the settlement cycle from T+2 to T+1. These rules also enhance institutional trade processing and establish new requirements for broker-dealers and investment advisers. The SEC has progressively shortened the settlement cycle over the years, from T+3 in 1993 to T+2 in 2017, each time benefiting investors by reducing risks.

The SEC is actively monitoring market participants' preparations for the transition and coordinating with global regulatory authorities. To aid the transition, the SEC has issued a risk alert (see: https://www.sec.gov/files/risk-alert-tplus1-032724.pdf), FAQs (see: https://www.sec.gov/exams/educationhelpguidesfaqs/t1-faq), and an investor bulletin (see: https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-bulletins/new-t1-settlement-cycle-what-investors-need-know-investor-bulletin).

Litigation and Enforcement

SEC Charges Five Investment Advisers for Marketing Rule Violations

04.12.24

The SEC has announced the resolution of charges against five registered investment advisers for infractions of the Marketing Rule. The implicated firms are GeaSphere LLC, Bradesco Global Advisors Inc., Credicorp Capital Advisors LLC, InSight Securities Inc., and Monex Asset Management Inc. Collectively, these firms have agreed to remit penalties totaling $200,000.

Key Findings:

- The firms published hypothetical performance data on their websites without implementing sufficient policies to ensure the data's relevance to the intended audience, as mandated by the Marketing Rule.
- Bradesco, Credicorp, InSight, and Monex received reduced penalties due to proactive corrective measures undertaken prior to SEC intervention.

Specific Violations by GeaSphere LLC:

- Disseminated false and misleading statements in advertisements.
- Advertised misleading model performance.
- Failed to substantiate performance claims.
- Neglected to enter into written agreements for endorsements.
- Committed recordkeeping and compliance violations.
- Made misleading statements to a registered investment company client, which were subsequently included in the client’s prospectus.

All the firms, without admitting or denying the SEC's findings, consented to orders acknowledging violations of the Investment Advisers Act of 1940. These orders require the firms to be censured, cease and desist from further violations, and adhere to specific undertakings.

This is the second set of cases that the SEC has brought as part of an ongoing targeted sweep concerning Marketing Rule violations after charging nine advisory firms in September 2023.

Fifth Circuit Strikes Down Private Fund Adviser Rules

06.06.24

On June 5, 2024, the Fifth U.S. Circuit Court of Appeals unanimously struck down the SEC Private Fund Adviser Rules (the rules), citing a lack of statutory authority. This decision nullifies the SEC’s recent regulatory efforts on private funds and their advisers and may significantly impact future SEC rulemaking. Below, we outline the court’s decision and examine its immediate and potential impacts on private funds and their advisers.

Background

In August 2023, the SEC adopted the rules to enhance regulation of private fund advisers and protect investors. The rules aimed to:

- Increase transparency in compensation schemes, sales practices, and conflicts of interest.
- Restrict activities deemed harmful to investors.
- Limit preferential treatment for certain investors.
- Impose requirements on adviser-led secondaries.
- Mandate annual audits for private funds.

The SEC estimated compliance costs at $5.4 billion and millions of employee hours. Claiming authority under Sections 206(4) and 211(h) of the Investment Advisers Act of 1940 (the Advisers Act), the SEC faced a petition for review in September 2023 from several industry associations. They argued the SEC exceeded its authority, the rules were not a logical outgrowth of the proposed rules, it was arbitrary and capricious under the Administrative Procedure Act (APA), and the SEC failed to consider its impact on efficiency, competition, and capital formation.

The Fifth Circuit's Decision

The Fifth Circuit agreed with the petitioners that the SEC exceeded its statutory authority in adopting the rules under Sections 206(4) and 211(h) of the Advisers Act, and thus did not address the other issues raised by the petitioners.

The SEC's Lack of Authority Pursuant to Section 211(h) of the Advisers Act

The court noted that Section 211(h), added by the Dodd-Frank Act, primarily pertains to "retail customers" and explicitly prohibits defining "customer" to include private fund investors. Therefore, the court ruled that Section 211(h) was intended to apply to retail customers, not private fund advisers.

The SEC's Lack of Authority Pursuant to Section 206(4) of the Advisers Act

While Section 206(4) allows the SEC to prevent fraudulent practices, the court found that the SEC did not establish a rational connection between fraud and the rules. The court emphasized that Section 206(4) requires the SEC to define fraudulent acts before prescribing preventive measures, which was absent in the rules. The court also noted that Section 206(4) does not authorize general disclosure and reporting obligations, which are explicitly provided for in other parts of the Advisers Act. The court ruled that the SEC conflated "lack of disclosure" with "fraud" or "deception" without establishing a duty to disclose to fund investors.

What This Means for Private Fund Advisers

Private fund advisers are not required to comply with the rules, allowing them to focus resources on existing regulatory requirements. The decision may impact other SEC regulations relying on Sections 206(4) or 211(h), such as the Safeguarding Rule and certain provisions of the Marketing Rule, which may face challenges based on this precedent.

Conclusion

The Fifth Circuit's ruling is a significant victory for the private funds industry, promoting reasonable regulation. However, it is uncertain whether the SEC will appeal the decision or attempt to re-propose the rule under different statutory provisions. Some believe the SEC might resort to "regulation by enforcement," using its existing authority to target the same activities addressed in the rules through examinations and enforcement actions. This could lead to increased examination sweeps and enforcement referrals, posing costs and reputational risks for private fund advisers. Regardless of the SEC's next steps, private fund advisers should maintain compliance with current regulations and be prepared for potential new regulatory challenges.

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