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Investment Management & Funds Regulatory Update - February 2024

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In this issue, we discuss among other things updated FAQs regarding compliance with the marketing rule under the Advisers Act, and amendments to Form PF.

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Rules and regulations

SEC staff updates FAQs regarding compliance with Advisers Act marketing rule

On February 6, 2024, SEC staff (the Staff) issued an update to FAQs (the FAQ) with responses to questions concerning compliance with Rule 206(4)-1 (the Marketing Rule) under the Investment Advisers Act of 1940. In particular, the Staff clarified their position on the following question:

Must gross and net performance shown in an advertisement always be calculated using the same methodology and over the same time period?

According to the FAQ, the Marketing Rule requires that any presentation of gross performance be accompanied by a presentation of net performance that has been calculated over the same time period and using the same type of return and methodology as the gross performance. The Staff noted that certain advisers may wish to present gross internal rate of return (Gross IRR) that is calculated from the time an investment is made (without reflecting fund borrowing or subscription facilities) and then present net internal rate of return (Net IRR) that is calculated from the time investor capital has been called to repay such borrowing. The FAQ clarifies that an adviser cannot present Gross IRR that excludes the impact of subscription facilities, while presenting Net IRR that includes the impact of subscription facilities. The Staff noted that such a presentation would violate the Marketing Rule's requirements that (i) any presentation of gross performance be accompanied by a presentation of net performance that has been calculated over the same time period and using the same type of return and methodology as the gross performance and (ii) net performance be presented in a format designed to facilitate comparison with gross performance.

The FAQ clarifies that if an adviser were to include in an advertisement the Gross IRR of a private fund calculated from before capital commitments are called, then it would need also to show the Net IRR calculated from the same time before

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capital commitments are called (i.e., including the effect of fund-level subscription facilities in its calculation).

The FAQ also clarifies that an adviser would violate the general prohibitions of the Marketing Rule 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. The Staff noted that presenting only Net IRR that includes the impact of fund-level subscription facilities could mislead investors by suggesting that the fund's advertised performance is similar to the performance that the investor has achieved from its investment in the fund alone.

SEC adopts amendments to Form PF to monitor systemic risk and bolster the SEC's regulatory oversight of private fund advisers

Summary

In a February 8, 2024 release (Adopting Release), the Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC) announced their concurrent adoption of amendments (Amendments) to Form PF.

The SEC also adopted amendments to Rule 204(b)-1 under the Investment Advisers Act to revise instructions for requesting a temporary hardship exemption. The Amendments are designed to assist the SEC in identifying trends in the private funds industry that could create systemic risk, improve data quality and comparability, and reduce reporting errors by providing greater insight into the operations and strategies of private funds. Some key takeaways of the Amendments include:

- A more prescriptive approach for reporting complex fund structures (e.g., reporting separately each component fund of a master-feeder arrangement and parallel fund structure).
- Updated reporting timelines such that large hedge fund advisers and large liquidity fund advisers must update Form PF within a certain number of days after the end of each calendar quarter, instead of at the end of each fiscal quarter.

Background

In 2011, the SEC and CFTC adopted Form PF, which an adviser to private funds, including those that also are registered with the CFTC as a commodity pool operator or commodity trading adviser, must file if: (1) it is registered or required to register with the SEC as an investment adviser, (2) it manages one or more private funds, and (3) the adviser and its related persons collectively had at least $150 million in private fund assets under management as of the last day of its most recently completed fiscal year. The SEC and the Financial Stability Oversight Council (FSOC) use Form PF to gather confidential information regarding the operations and strategies of private funds in order to monitor and assess systemic risk and can use the information gathered in examinations, investigations, and investor protection efforts and other regulatory programs.

Adopted amendments

The Amendments will enhance reporting to provide greater insight into private funds' operations and strategies and will require additional information about advisers and the private funds they manage, including more detailed information regarding hedge fund investment strategies, counterparty exposures, and trading and clearing mechanisms. The Amendments will also implement the following changes, among other things:

Amend how advisers report complex structures

Formerly, advisers could report complex fund structures in the aggregate or separately so long as their reporting was consistent. The SEC view is that such practices could obscure risk profiles and make comparing complex structures difficult. Under the Amendments, advisers generally will report each component fund, like master-feeder arrangements and parallel fund structures, separately, except where a feeder fund invests all its assets in a single master fund, U.S. Treasury bills, and/or "cash and cash equivalents." Under the Amendments, advisers will continue to aggregate structures to determine if they continue to meet a reporting threshold, but would disregard any holdings of a feeder fund in the master fund's equity for such purposes. The Amendments also require advisers to identify trading vehicles used by reporting funds and report them on an aggregated basis to provide greater visibility into such trading vehicles for the SEC and FSOC.

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Enhance reporting for hedge funds

Section 1C of Form PF requires advisers to provide information on the hedge funds they advise. The Amendments will require advisers to report additional information regarding operations and strategies. Instead of the former approach, which allowed advisers the flexibility to report a fund's strategy as of the data reporting date or throughout the reporting period, advisers would have to report an investment strategy that best describes the fund's strategies on the last day of the reporting period under the Amendments. The SEC's determination is that this approach will improve the quality of the data it receives by establishing a consistent format for reporting how a fund's strategy changes over time. In addition, the Amendments add more granular categories for equity and credit strategies, such as real estate and digital assets, which have become more commonly pursued by hedge funds since the adoption of Form PF and add a drop-down menu for advisers to select from. By obtaining information that is more granular, the SEC's view is that it will conduct more targeted analysis and improve comparability among advisers and hedge funds. Moreover, in the SEC's view, these changes will allow the SEC to improve its ability to identify investor protection issues during periods of stress.

Update reporting timelines

The SEC view is that former reporting timelines, which allowed large hedge fund and large liquidity fund advisers to update their Form PF after the end of the fiscal quarter, significantly delayed the SEC from receiving a full data set for a calendar quarter. As the SEC noted, for example, a large hedge fund adviser whose fiscal quarter ends at the end of March would have filed data for the first calendar quarter at the end of May, whereas a large hedge fund adviser whose fiscal quarter ends in May would not have filed its March data until the end of July. Under the Amendments, large fund advisers will be required to update Form PF a certain number of days (i.e., 60 days for large hedge fund advisers and 15 days for large liquidity fund advisers) after the end of each calendar quarter, as opposed to their fiscal quarter. Other advisers will continue to file annual updates within 120 calendar days after the end of their fiscal year. The Amendments are intended to provide a more complete data set sooner and to improve the efficiency and effectiveness of investor protection efforts and systemic risk assessment.

Remove aggregate reporting for large hedge fund advisers

The Amendments also remove the requirement for large hedge fund advisers to report certain aggregated information about the hedge funds they advise. The SEC noted that aggregation can lead to inconsistencies between data reported on an aggregate basis in section 2a and on a per fund basis in section 2b. In addition, the SEC believes that aggregated reporting for funds with different strategies and activities can mask directional exposure of individual funds.

The Amendments will become effective one year after publication in the Federal Register. The compliance date for the Amendments is the same as the effective date.

FinCEN proposes new AML/CFT compliance requirements for investment advisers

FinCEN issued its long-awaited proposed rule that would impose AML/CFT obligations on certain investment advisers, such as requirements to implement and maintain an AML/CFT compliance program and monitor for and report suspicious activity. For further information, please see our recent client update on this topic.

Litigation

SEC settles with investment adviser for alleged disclosure failures regarding social media index and role of a social media influencer

On February 16, 2024, the SEC issued an order (the VEAC Order) instituting and settling administrative and cease-and-desist proceedings against registered investment adviser Van Eck Associates Corporation (VEAC) for allegedly failing to disclose details of a licensing agreement and promotion plan associated with the launch of its VanEck Social Sentiment ETF (BUZZ ETF).

In March 2021, VEAC launched BUZZ ETF, an exchange traded fund that would track the BUZZ NextGen AI US Sentiment Leaders Index (BUZZ Index), which was developed by a third-party Index Provider (the Index Provider). In the months prior to the launch, VEAC negotiated the economic terms of its license of the BUZZ Index with the Index

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Provider. According to the VEAC Order, in October 2020, VEAC had proposed that it would pay the Index Provider a fee equal to 20% of the management fee it received from the ETF in exchange for an exclusive license to use the BUZZ Index in the United States.

Thereafter, the provider of BUZZ Index informed VEAC that they intended to retain a "well-known and controversial" social media influencer to promote the launch of BUZZ ETF. As a result, VEAC agreed to change the proposed licensing fee structure to a sliding scale fee structure, providing BUZZ Index "with a larger percentage of the fee when assets under management of the BUZZ ETF met certain thresholds." Under this sliding scale, the Index Provider would receive at least 20% of the net management fee VEAC would receive from the ETF, and as much as 60% of the management fee if the new ETF exceeded $1.25 billion in assets under management within 18 months of its launch. The social media influencer was also offered and accepted an ownership interest in the Index Provider.

Under Section 15(c) of the Investment Company Act, a registered investment company (such as the BUZZ ETF) may not enter into or renew an advisory contract unless the terms of the contract are approved by a majority of the investment company's independent directors. Among other things, Section 15(c) also imposes a duty on the advisor "to furnish, such information as may reasonably be necessary to evaluate the terms" of such an advisory contract. The VEAC Order states that information "reasonably necessary" to evaluate the terms of an advisory contract includes "the extent to which economies of scale would be realized" as the ETF increases in size, and "whether fee levels reflect these economies of scale," as well as "the costs of the services to be provided and profits to be realized by the investment adviser."

The SEC alleges that VEAC failed to inform the independent trustees of the VanEck ETF Trust (Board) of a number of material aspects of the arrangement with the Index Provider before that arrangement was approved, including the Influencer's planned involvement or the economic terms of the sliding scale arrangement with the Index Provider that would provide a greater percentage of fees as the BUZZ ETF grew in size (which the SEC notes would have been relevant to profitability and analysis of economies of scale). VEAC allegedly misstated the terms of the licensing agreement with the Index Provider, noting that it was "still in [the] process of finalizing and signing the index licensing agreement."

The SEC also alleges that VEAC failed to disclose to the Board the "controversies surrounding the Influencer, and the corresponding brand risk to VEAC and VEAC-advised ETFs." By early 2021, the VEAC Order states, VEAC was advised by a public relations firm that because the Influencer was a spokesman for the BUZZ Index, "the public would likely assume" he was also a spokesperson for BUZZ ETF; VEAC allegedly did not advise the Board of the risk that the Influencer's views might be associated with the BUZZ ETF.

Finally, the SEC also alleges that VEAC failed to adopt or implement "policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder," including adequate written policies and procedures concerning the furnishing of accurate information to Board members reasonably necessary to evaluate the terms of the contract and launch of the ETF.

On account of the conduct alleged, the SEC asserts that VEAC violated Section 15(c) of the Investment Company Act, Sections 206(2) and 206(4) of the Advisers Act, and Rule 206(4)-7 thereunder. VEAC agreed to pay a civil money penalty of $1,750,000, to cease and desist from future violations, and to be censured; the VEAC Order states that the SEC "considered remedial acts undertaken by VEAC" without specifying the relevant remedial acts or the impact of such acts on the penalties imposed or impact on investors.

The basic aspects of the VEAC Order are not novel, as the material terms of advisory contracts and other arrangements between a fund and its advisers are an area of perennial SEC focus. However, the VEAC Order does highlight that the use of a social media influencer to promote a fund may be considered a material risk to the fund that should be adequately explored and disclosed by an adviser to the fund's independent directors, and adequately evaluated by the fund's independent board. Finally, the SEC's invocation of Advisers Act Rule 206(4)-7 suggests that advisers evaluating the use of a social media influencer should ensure the adoption of written policies and procedures to ensure adequate disclosure and consideration of such arrangement.

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