Davis Polk

Investment Management & Funds Regulatory Update - April 2024

April 30, 2024 | Client Update | 13-minute read

In this issue, we discuss the SEC Examinations Division's risk alert regarding compliance with the Advisers Act Marketing Rule, and recent enforcement actions involving, among other things, off-channel communications and alleged violations of the Marketing Rule with respect to hypothetical performance.

Table of Contents

Rules and regulations

SEC adopts reforms relating to investment advisers operating exclusively through the internet

In a March 27, 2024 release (Adopting Release), the SEC adopted amendments to Rule 203A-2(e) (the Internet Adviser Exemption) under the Advisers Act. The Internet Adviser Exemption allows certain investment advisers to register with

the SEC, rather than with state securities authorities, if they meet certain conditions, including those relating to the investment adviser's use of an interactive website to advise clients.

According to the Adopting Release, the amendments are designed to modernize the Internet Adviser Exemption to reflect the evolution in technology and the investment adviser industry since the rule's adoption in 2002 and to better align current practices in the investment adviser industry with Congress's intended allocation of responsibility between the SEC and the states. In the Adopting Release, the SEC noted that there has been an uptick in the number of investment advisers relying exclusively on the Internet Adviser Exemption to register with the SEC. The SEC noted that based on Form ADV data, the number of investment advisers relying exclusively on the exemption has grown from approximately 107 investment advisers as of December 2015 to 261 investment advisers as of June 2023.

The amendment requires investment advisers relying on the Internet Adviser Exemption to at all times have an operational interactive website through which the investment adviser provides investment advisory services to one or more clients. The amendment also eliminates the de minimis exception in the current rule, which currently permits an investment adviser relying on the exemption to have fewer than 15 non-internet clients in a 12-month period. As a result, an investment adviser relying on the exemption is now required to provide advice to all of its clients exclusively through an operational interactive website. Finally, the amendment makes certain corresponding changes to Form ADV. The amended rule is effective July 8, 2024, with a compliance date on March 31, 2025.

Industry update

SEC Examinations Division staff issues risk alert on initial observations regarding the Advisers Act Marketing Rule

On April 17, 2024, the SEC's Division of Examinations staff (staff) issued a risk alert that identified initial observations regarding investment advisers' compliance with amended Rule 206(4)-1 (Marketing Rule) under the Advisers Act. The staff noted that the purpose of the risk alert is to promote compliance with the Marketing Rule-related items contained in Form ADV, Advisers Act Rule 206(4)-7 (Compliance Rule), Advisers Act Rule 204-2 (Books and Records Rule), and the general prohibitions set out in subsections (a)(1) to (a)(7) of Marketing Rule.

Observations regarding compliance with the Compliance Rule, Books and Records Rule and Form ADV.

The Risk Alert outlined observations surrounding whether investment advisers had adopted and implemented the written policies and procedures to prevent violations of the Advisers Act, including the Marketing Rule thereunder:

- **Compliance Rule**: the staff has observed that advisers' policies and procedures generally included processes to effectuate their compliance with the Marketing Rule, including training for staff members on the Marketing Rule's requirements and internal updates to written marketing-related policies and procedures. However, the staff also observed deficiencies in advisers' policies and procedures that resulted in gaps for preventing violations of the Marketing Rule and/or the Books and Records Rule, such as policies and procedures that:
  - "Consisted only of general descriptions and expectations related to the Marketing Rule.
  - Did not address applicable marketing channels utilized by the advisers, such as websites and social media.
  - Were informal rather than in writing.
  - Were incomplete, not updated, or partially updated for certain applicable marketing topics.
  - Were not tailored to address advisers' specific advertisements (e.g., policies and procedures to address the General Prohibitions, and advertising requirements for testimonials, endorsements, and third-party ratings utilized by advisers in advertisements).
  - Did not adequately address the preservation and maintenance of advertisements and related documents, such as copies of any questionnaires or surveys used in the preparation of a third-party rating (in the event the adviser has received such documents) included or appearing in any advertisement."
- **Books and Records Rule**: the staff has observed that advisers have generally updated their policies and procedures to adhere to the Marketing Rule requirements regarding books and records maintenance and preservation requirements, but that deficiencies in compliance have included advisers failing to maintain a copy of questionnaires

that were used in preparation of a third-party rating, failing to maintain copies of information posted to social media, and failing to maintain documentation to support performance claims included in advertisements.

- **Form ADV**: the staff has observed that at the time of their examinations, many advisers had updated their Form ADVs, particularly the items pertaining to advertising, but that deficiencies in compliance have included inaccurately reporting on Form ADV, Part 1A, that advisers' advertisements did not include third-party ratings when such ratings were included on websites or social media posts, performance results when such results were included in marketing materials, and hypothetical performance, when such performance was included in advertisements. The staff also observed Form ADVs that: used outdated language referencing the prior Cash Solicitation Rule (Advisers Act Rule 206(4)-3), inaccurately stated that no referral arrangements existed, and omitted material terms and compensation of referral arrangements on Form ADV, Part 2A, Item 14.

Observations regarding compliance with the general prohibitions of the Marketing Rule

According to the risk alert, the staff's review for Marketing Rule compliance has also assessed whether investment advisers have disseminated advertisements that violate any of the following general prohibitions:

- **Untrue facts or material omissions**: whether the advertisements include an untrue statement or omission of a material fact, making the statement misleading.
- **Substantiation**: whether the advertisements include a material statement of fact that the adviser does not have a reasonable basis for believing it will be able to substantiate upon demand by the SEC.
- **Misleading implications**: whether the advertisements include information that would reasonably be likely to cause an untrue or misleading implication or inference to be drawn concerning a material fact relating to the adviser.
- **Treatment of material risks and limitations**: whether the advertisements discuss any potential benefits to clients or investors connected with or resulting from the adviser's services or methods of operation without providing fair and balanced treatment of any associated material risks or limitations.
- **Fair and balanced investment advice**: whether the advertisements reference specific investment advice provided by the adviser in a manner that is not fair and balanced.
- **Fair and balanced performance results**: whether the advertisements include or exclude performance results, or present performance time periods, in a manner that is not fair and balanced.
- **Other misleading material**: whether the advertisements include information that is otherwise materially misleading.

The SEC staff observed various deficiencies related to the Marketing Rule's general prohibitions, including the following:

Untrue statements of material fact and unsubstantiated statements of material fact:

- Advertisements stating that the investment advisers were "free of all conflicts," when in fact, actual conflicts existed.
- Advertisements stating material facts regarding the investment advisers' businesses that were inaccurate, including statements indicating a network of personnel perform advisory services for clients, when in fact, only a sole individual performed such services, and statements representing erroneous adviser personnel qualifications relating to experience, education, and professional designations.
- Advertisements describing material facts about advisory services or products offered that were inaccurate, including referencing certain investment mandates that, in fact, did not exist, falsely claiming investment processes were validated by professional institutions, indicating risk tolerances were considered when they were not, referring to a list of approved securities that did not exist, referencing securities screening policies that did not exist, and misrepresenting the advisers' client base.
- Advertisements publicizing the receipt of certain awards or accolades that, in fact, were not received.

Omission of material facts or misleading inference:

- Advertisements containing statements indicating advisers differed from other advisers because they acted in the "best interests of clients," without further disclosing that all investment advisers have such fiduciary duty.
- Advertisements recommending certain investments on media platforms without disclosing conflicts of interests attributed to the compensation paid to or received by the advisers for such recommendations.
- Advertisements containing untrue or misleading claims, including statements that advisers were "seen on" national media without disclosing that appearances were paid advertisements and advertising images of celebrities in

marketing materials implying such celebrities endorse the firms when they did not.

- Advertisements containing untrue or misleading performance claims, including that cumulative profits that advisers believed were not achievable or impossible without unlimited money to invest, presenting performance information without adequate disclosure regarding share classes included in such performance returns, using lower fees in calculations for net of fees performance returns than were offered to the intended audience and omitting material information on fees and expenses used in calculating returns.
- Advertisements citing to SEC registration implying such registration indicated a particular level of skill or ability or that the SEC had approved and passed upon the advisers' business practices.
- Advertisements containing third-party ratings implying the advisers were the only and top recipients of awards when there were multiple recipients, and indicating that advisers were highly rated by organizations without disclosing that the methodologies for such ratings were based on factors unrelated to the quality of investment advice.
- Advertisements including misleading testimonials.
- Performance advertisements containing misleading information, such as benchmark index comparisons that did not define the index or provide sufficient context, performance presentations including outdated market data information or investment products that were no longer available to clients, statements or presentations regarding advisers' performance track record with securities not purchased by the advisers in a similar manner in client accounts, claims that advisers achieved above-average performance results without disclosing that the advisers did not yet have clients or performance track records, and investment recommendations containing performance information without adequate disclosure to provide context (e.g., 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:

- Advertisements including statements about the potential benefits of the advisers' services or methods of operation that did not appear to provide fair and balanced treatment of material risks or limitations associated with the potential benefits, such as social media advertisements showing performance without disclosing material risks and limitations.

References to specific investment advice that were not presented in a fair and balanced manner:

- Advertisements including only the most profitable investments or excluding certain investments without disclosing sufficient information on the rationale for the exclusion.

Inclusion or exclusion of performance results or time periods in manners that were not fair and balanced:

- Advertisements that did not disclose the time period or did not disclose whether the returns were calculated for the same time period as performance information included elsewhere in the same advertisement.
- Advertisements that included the performance of only realized investment information in the total net return figure and excluded unrealized investments.

Advertisements that were otherwise materially misleading:

- Advertisements appearing to otherwise be materially misleading, such as presenting disclosures in an unreadable font on websites or in videos.

In the risk alert, the staff urged advisers to reflect on their own practices, policies, and procedures and to implement modifications as necessary to their training, supervisory, oversight, and compliance programs.

Litigation

SEC settles with five investment advisers for alleged Marketing Rule violations related to advertising hypothetical performance

On April 12, 2024, the SEC announced five orders (Marketing Rule Orders) instituting and settling administrative and cease and desist proceedings against five registered investment advisers, GeaSphere LLC, Bradesco Global Advisors Inc., Credicorp Capital Advisors LLC, InSight Securities Inc., and Monex Asset Management Inc. The Orders found that the five firms were allegedly advertising "hypothetical performance to the general public 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, as required by the Marketing Rule." These orders follow nine similar orders that were announced in September 2023.[1]

Under the Marketing Rule (i.e., Rule 206(4)-1 under the Advisers Act), "hypothetical performance" information includes performance results that were not actually achieved by any portfolio of the relevant adviser, such as performance results for model portfolios, backtested performance (results generated by applying a strategy to prior time periods when the strategy in question was not in use), and projected future results. Advisers are generally prohibited from advertising using hypothetical performance unless, among other things, the adviser adopts policies and procedures reasonably designed to ensure that the hypothetical performance presented is relevant to the likely financial situation and investment objectives of the intended audience. The Marketing Rule Orders note that "[A]dvisers generally would not be able to include hypothetical performance in advertisements directed to a mass audience or intended for general circulation . . . because the advertisement would be available to mass audiences, an adviser generally could not form any expectations about their financial situation or investment objectives."

According to the Marketing Rule Orders, each of the five advisers included hypothetical performance information on their public websites; such information included results from model portfolios (GeaSphere, InSight, Monex, Credicorp, Bradesco) as well as backtested performance (GeaSphere). Four of the five advisers, InSight Securities, Monex Asset Management, Credicorp Capital Advisors, and Bradesco Global Advisors, removed hypothetical performance information from their public website after the Compliance Date under the Marketing Rule, but before SEC staff contacted them about the information.

In addition to presenting hypothetical performance information, GeaSphere allegedly made false or misleading statements, such as claiming in a promotional video that it did not "charge clients twice," for fund management fees and advisory fees, when in fact clients who invested in the fund paid both fees, and presented inaccurate and unsubstantiated performance information. GeaSphere was also charged with compensating two unaffiliated accounting firms for endorsements without having a written agreement with either firm, failing to substantiate documents for material statements of fact when requested by the SEC, failing to keep adequate books and records, and other compliance failures responsive to the requirements in its compliance manual.

On account of the conduct alleged, the SEC asserts that GeaSphere violated Sections 206(4), 206(2), and 204 of the Advisers Act and Rules 206(4)-1(a), 206(4)-1(b), 206(4)-1(d), 206(4)-7, 206(4)-8, 204-2(a)(11) and (16) thereunder. InSight, Monex, Credicorp, and Bradesco were charged with violating Section 206(4) of the Adviser's Act and Rule 206(4)-1(d) thereunder. GeaSphere was also charged with violating Section 34(b) of the Investment Company Act. All five firms agreed to pay a civil money penalty of $200,000 in combined penalties, to cease and desist from future violations, and to be censured. GeaSphere agreed to pay $100,000, while the other four firms agreed to pay civil penalties in the range of $20,000 to $30,000. Bradesco, Credicorp, InSight, and Monex received reduced penalties due to corrective steps taken in advance of SEC contact.

SEC settles off-channel communications, recordkeeping violations, with investment adviser

On April 3, 2024, the SEC announced another in a substantial series of settlements regarding so-called "off-channel communications," that is, business communications among employees using messaging services other than the employer-provided communications services. This order (Senvest Order) was issued against Senvest Management, LLC, a New York-based registered investment adviser.

Pursuant to Section 204 of the Advisers Act and Rule 204-2 thereunder, advisers must preserve and retain certain records, including certain written communications related to the adviser's business. Senvest's policies and procedures stated that Senvest would "retain all electronic communications that it sends and receives," and in that regard, forbid employees from using unapproved communication methods for business purposes except in emergencies or when communications were disrupted, in which case employees were required to copy the content of such communications to firm messaging systems so that the content could be archived.

According to the Senvest Order, from January 2019 to December 2021, Senvest employees sent and received "thousands of business-related messages using off-channel communications"; Senvest allegedly failed to "access employees' personal devices" to confirm that employees were following Senvest's policy barring off-channel communications, and, as a result, some communications were deleted as certain employees' personal devices were set to automatically delete such messages after 30 days. Because of such failures, the SEC alleges, Senvest "likely deprived the Commission" of off-channel communications that would have been responsive to SEC requests and subpoenas propounded during the relevant time period.

In addition, Senvest allegedly also failed to properly implement its securities transaction pre-clearance policies, resulting in Senvest employees transacting in securities without obtaining preclearance.

On account of the conduct described above, Senvest allegedly violated Sections 204, 204A, and 206(4) of the Advisers Act and Rules 204-2, 204A-1, and 206(4)-7 thereunder. Senvest agreed to retain a compliance consultant, to cease and desist from future violations, to be censured, and to pay a civil money penalty of $6.5 million.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

Leor Landa
+1 212 450 6160
leor.landa@davispolk.com

Sijia Cai
+1 212 450 3071
sijia.cai@davispolk.com

Michael S. Hong
+1 212 450 4048
michael.hong@davispolk.com

Gregory S. Rowland
+1 212 450 4930
gregory.rowland@davispolk.com

Lee Hochbaum
+1 212 450 4736
lee.hochbaum@davispolk.com

Jennifer Grant Cooper
+1 212 450 4492
jennifer.cooper@davispolk.com

Sarah E. Kim
+1 212 450 4408
sarah.e.kim@davispolk.com

Benjamin Milder
+1 212 450 3171
benjamin.milder@davispolk.com

Marc J. Tobak
+1 212 450 3073
marc.tobak@davispolk.com

James H.R. Windels
+1 212 450 4978
james.windels@davispolk.com

1 See SEC Sweep into Marketing Rule Violations Results in Charges Against Nine Investment Advisers, Sept. 11, 2023.