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Investment Management Regulatory Update - September 2022

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In this issue we discuss, among other things, a Division of Examinations risk alert relating to the Marketing Rule, SEC Chair Gary Gensler's remarks regarding crypto tokens and securities regulation, and recent enforcement actions involving private fund advisers.

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Industry update

SEC Division of Examinations issues risk alert on examinations and new investment adviser Marketing Rule

Introduction

On September 19, 2022, the Division of Examinations (Division) issued a risk alert to inform SEC-registered investment advisers (*advisers*) about upcoming areas of focus for examinations relating to the amended Rule 206(4)-1 (Marketing Rule) under the Investment Advisers Act of 1940 (Advisers Act). The amendments created a single rule that replaced the previous advertising and cash solicitation rules under the Advisers Act.

Any advertisements disseminated by advisers on or after November 4, 2022, the compliance date for the Marketing Rule (Compliance Date), must comply with the requirements of the Marketing Rule. In addition, amended Rule 204-2 under the Advisers Act requires advisers to retain certain records, such as records of all advertisements they disseminate,

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including internal working papers, performance related information and documentation for oral advertisements, testimonials and endorsements.

Initial Marketing Rule areas of review

The Division notes that its national initiatives and examinations relating to the Marketing Rule will focus on, but not be limited to, the following areas:

- **Marketing Rule policies and procedures**: The staff will review whether advisers have adopted and implemented written policies reasonably designed to prevent violations of the Advisers Act and the rules thereunder, including the Marketing Rule. In the adopting release for the Marketing Rule, the SEC noted that these policies should include "objective and testable means reasonably designed to prevent violations of the final rule in advertisements the adviser disseminates."
- **Substantiation requirement**: The staff will review whether advisers have a reasonable basis for believing that they will be able to substantiate material statements of fact in advertisements. According to the risk alert, this can be established by, among other means, showing (i) records contemporaneous with the advertisement demonstrating the basis for the adviser's belief or (ii) policies and procedures designed to address how the requirement is to be met. If an adviser cannot substantiate material claims of fact made in an advertisement upon request, the SEC staff will presume that the adviser did not have a reasonable basis for its belief.
- **Performance advertising requirements**: The staff will review whether advisers are in compliance with performance advertising requirements under the Marketing Rule, including the prohibitions on the following in an advertisement:
  - *Gross performance* - Gross performance, unless the advertisement also presents net performance;
  - *Prescribed time periods* - Any performance results, except the performance results of private funds, unless such results are provided for specific time periods (specifically, 1-, 5- and 10-year periods);
  - *Certain statements by the SEC* - Any statement that the SEC has approved or reviewed any calculation or presentation of performance results;
  - *Related performance* - If an advertisement includes the performance of portfolios other than the portfolio being advertised, performance results from fewer than all portfolios with substantially similar investment policies, objectives and strategies as the portfolio being offered in the advertisement (with limited exceptions);
  - *Extracted performance* - Performance results of a subset of investments extracted from a portfolio, unless the advertisement provides, or offers to provide promptly, the performance results of the total portfolio;
  - *Predecessor performance* - Predecessor performance, unless the personnel primarily responsible for achieving the prior performance manage accounts at the advertising adviser and the accounts that were managed by those personnel at the predecessor adviser are sufficiently similar to the accounts that they manage at the advertising adviser. In addition, the advertising adviser must include all relevant disclosures clearly and prominently in the advertisement.

The Division notes that, by sharing its initial examination review areas for the Marketing Rule, it is encouraging advisers to review their practices, policies and procedures and to make any necessary updates to their compliance programs ahead of the Compliance Date.

Remarks of SEC Chair Gary Gensler on "Kennedy and Crypto" at SEC Speaks 2022

On September 8, 2022, SEC Chair Gary Gensler addressed the Practising Law Institute's SEC Speaks event to share his thoughts on crypto tokens and crypto intermediaries. He opened with a quote by the first SEC Chair, Joseph Kennedy: "No honest business need fear the SEC." Chair Gensler noted that this still rings true today and provided a brief history of securities regulations, emphasizing their importance in protecting investors.

Chair Gensler stated that, in his opinion, "the vast majority [of crypto tokens] are securities." Chair Gensler explained that "the investing public is buying or selling crypto security tokens because they're expecting profits derived from the efforts of others in a common enterprise[,]" the core considerations under the Supreme Court's *Howey* test to determine what constitutes an investment contract, which is a security. Chair Gensler noted that it is important that investors receive disclosure on these tokens so they can make sound investment decisions and be protected against "fraud and manipulation," and therefore, he has asked SEC staff to work with entrepreneurs to have their tokens registered and regulated as securities, where appropriate.

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Chair Gensler also briefly discussed stablecoins, which he noted have similar features as money market funds, other securities and bank deposits, and therefore implicate important policy issues, such as appropriate safety and soundness protections, investor protections, and safeguards against illicit activity. Chair Gensler stated that depending on the stablecoin's attributes, such as payment of interest; mechanisms used to maintain value; or how the tokens are offered, sold, and used within the crypto ecosystem, they may be considered shares of a money market fund or other securities that require registration and investor protections.

Chair Gensler then went on to discuss crypto intermediaries. He noted, "Given that many crypto tokens are securities, it follows that many crypto intermediaries are transacting in securities and have to register with the SEC in some capacity." Chair Gensler noted that crypto intermediaries act as exchange funds, and they can perform broker-dealer functions, custodial and clearing functions, and lending functions, all of which are regulated by the securities laws and often require registration. Chair Gensler emphasized that because these intermediaries serve multiple functions, there are "inherent conflicts of interest and risks for investors." He noted that the SEC staff has been working with crypto intermediaries to register each of their functions and that he would be willing to work with Congress to provide the Commodity Futures Trading Commission (CFTC) with "greater authorities with which to oversee and regulate crypto non-security tokens and related intermediaries."

Chair Gensler concluded by reiterating the importance of the securities laws in fostering a thriving economy and their benefits to investors. "Investors, issuers, and our overall economy have benefited from those securities laws and the SEC's engagement for nearly 90 years. That oversight should not change just because the issuance and trading of certain securities is based on a new technology."

SEC Commissioner Uyeda outlines his rulemaking principles at the SEC Speaks conference 2022

On September 9, 2022, SEC Commissioner Uyeda delivered remarks at the SEC Speaks conference, outlining the factors and principles he will use to guide his upcoming policy decisions.

Commissioner Uyeda highlighted eight factors and principles that he believes are important in guiding the SEC's mission and its rulemaking process:

1. The SEC should maintain its focus on promoting investor protection, encouraging capital formation, and developing fair and orderly markets in order to promote high quality regulatory standards.
2. The SEC should evaluate proposals with a goal to achieve regulations that are both effective and cost-efficient.
3. Though the SEC is designed to enjoy a degree of independence and insulation from political accountability to the voters, the SEC should ensure that it does not attempt to resolve complex societal questions unrelated to financial market practice, and should stay in the bounds of its statutory framework enacted by Congress and limited by the courts.
4. In its decision making process, the SEC should consider the cumulative economic impact and cost of the proposed rules and any regulatory alternatives, and not just the impact or cost of individual regulations.
5. The SEC should not take steps to deter robust public commentary. Comment periods that are provided should be longer than 30 days, as short comment periods can deter otherwise interested persons from contributing to the rulemaking process, thus failing to provide the SEC with a more fulsome view of public perspectives.
6. The SEC should not take rulemaking shortcuts that undercut the robustness of protections required by the Administrative Procedure Act, such as reopening the comment period of rules that had expired over five years prior without updating the accompanying analyses or discussion.
7. In order to develop a more transparent and understandable regulatory framework, new interpretations of existing statutes and rules should not be issued through enforcement actions, which lead regulated entities to guess how their business models would be treated based upon the facts and circumstances of another case. Regulations should instead be developed through the rulemaking process with contributions from market participants, which leads to informed decisions and better-crafted rules.
8. The SEC should be willing to tackle difficult and complex issues in underdeveloped regulatory spaces, such as crypto assets, by proposing rules or issuing interpretive releases and inviting public commentary, and not through piecemeal regulation by enforcement.

Litigation

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SEC conducts “targeted sweep” of custody rule and Form ADV violations

On September 9, 2022, the SEC issued nine related orders (Sweep Orders) instituting and settling administrative and cease-and-desist proceedings against nine advisers arising out of violations of the Advisers Act’s custody rule and failures to timely update Form ADV.

The custody rule under the Advisers Act imposes a number of requirements on registered investment advisers who have custody of client funds or securities. As an alternative to certain requirements, advisers to limited partnerships or other pooled investment vehicles may be deemed to have complied with certain requirements if the fund is subject to audit at least annually and “distributes [the fund’s] audited financial statements prepared in accordance with generally accepted accounting principles to all limited partners … within 120 days of the end of [the fund’s] fiscal year.” The Sweep Orders describe this as the “Audited Financials Alternative.”

Section 7.B.23.(a) of Form ADV, Part 1a requires advisers to disclose, among other things, whether advised private funds’ financial statements are subject to annual audit, whether those statements are prepared in accordance with GAAP, to identify the auditing firm and whether that firm is an independent public accountant registered with PCAOB, and whether the fund’s audited financial statements for the most recently completed fiscal year have been distributed to fund investors. Section 7.B.23.(h) requires advisers to state whether all of the audit reports prepared by the auditing firm for each of its advised funds, since the adviser’s last annual updating amendment, contained unqualified audit opinions. In Section 7.B.23.(h), the private fund investment adviser must state “Yes,” “No,” or “Report Not Yet Received.” If the adviser checks “Report Not Yet Received,” it must “promptly file an amendment” to update its response when the report is available.

Custody Rule violations

According to the Sweep Orders, eight of the nine advisory firms charged in the sweep violated the custody rule. While the specific facts and circumstances vary across the Sweep Orders, they generally allege that the firms violated the custody rule by relying upon the Audited Financials Alternative while:

– Failing to timely deliver audited financial statements to fund investors;

– Failing to timely deliver audited financial statements to certain fund investors; or

– Failing to have the required audits performed at all.

Form ADV violations

The Sweep Orders also allege that seven of the nine advisory firms charged in the sweep failed to update their Forms ADV as required. In most of the seven cases, the firms are alleged to have (accurately) responded to the question in Section 7.B.23.(h), “Do all of the reports prepared by the auditing firm for the private fund since your last updating amendment contain unqualified opinions” by checking the box stating “Report Not Yet Received.”

According to the SEC, the firms failed to update their Forms ADV when they later received the audited financial statements, in many instances until their next annual update. Some of the firms are alleged to have responded “Yes” to the question in Section 7.B.23(a)(1), “Are the private fund’s financial statements subject to an annual audit” and to Section 7.B.23.(h), “Do all of the reports prepared by the auditing firm for the private fund since your last updating amendment contain unqualified opinions” even though the fund’s annual financial statements were not subject to an annual audit (and had not been for several years).

Notably, one firm was charged with **only** a failure to update its Form ADV — it allegedly checked the “Report Not Yet Received” box in its Form ADV filed on March 30, 2021, received the audited financial statements the next day, March 31, 2021, but did not update its Form ADV until the next annual update.

On account of these alleged violations, the SEC charged these firms with violations of Sections 204(a) and/or 206(4) of the Advisers Act and Rules 204-1(a) and 206(4)-2 thereunder. Each of the firms agreed to pay civil money penalties ranging from $50,000 to $330,000.

The SEC’s press release announcing the sweep warned that “Firms are strongly encouraged to ensure their compliance with the Custody Rule and the related Form ADV reporting and amending obligations. In particular, private fund advisers registered with the SEC are reminded that per the instructions to Form ADV, Part 1A, Schedule D, Section 7.B.23.(h), ‘If

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you check 'Report Not Yet Received,' you must promptly file an amendment to your Form ADV to update your response when the report is available.'" Enforcement Division Director Gurbir S. Grewal also stated that "These actions show that the Commission expects private fund advisers to meet their obligations to secure client assets and will pursue those who fail to do so," while cautioning that "[c]ounsel should not assume that the Division will recommend similar resolutions going forward."

SEC charges investment adviser for alleged failures to disclose SPAC-related conflicts of interest

On September 6, 2022, the SEC issued an order (the Perceptive Order or the Order) instituting and settling administrative and cease-and-desist proceedings against Perceptive Advisors LLC (Perceptive), a New York-based investment adviser.

According to the Order, Perceptive manages the Perceptive Life Sciences Master Fund, Ltd (Fund). Between 2018 and 2020, Perceptive formed four SPACs; the three relevant to the Order were named ARYA II, ARYA III, and ARYA IV. The sponsors of ARYA II, ARYA III, and ARYA IV were majority-owned by the Fund, while five Perceptive personnel held a minority interest in the sponsors.

The SEC alleges that ownership of a minority interest in the SPAC sponsors created a material conflict of interest between the Fund and Perceptive personnel. The Order notes that minority ownership of the SPAC sponsor could lead Perceptive personnel to cause the Fund or other clients to make investments that would ensure that the SPACs completed business combinations that would generate sponsor compensation. According to the Order, the Fund invested $30 million in a PIPE transaction relating to ARYA II and $55 million in a PIPE transaction relating to ARYA III.

Despite these alleged conflicts of interest, Perceptive did not discuss the shared ownership of the sponsor with the board of directors of the Fund until March 2021 — after the PIPE transactions noted earlier — and allegedly failed to "fully and fairly" disclose the conflicts of interest in Perceptive's Form ADV or the offering memoranda for the Fund. Perceptive also did not disclose the shared ownership of the SPAC sponsors in statements to investors that described the SPACs as "fund-sponsored." The SEC also alleged that Perceptive failed to adopt and implement written compliance policies and procedures reasonably designed to provide appropriate disclosure regarding potential conflicts of interest relating to co-ownership of affiliated SPACs.

Separately, the SEC alleged that Perceptive failed to accurately report its "control purpose" in acquiring beneficial ownership of more than five percent of the securities of Amicus Therapeutics, Inc. (Amicus). The Order states that Perceptive filed a Schedule 13G amendment in February 2021 disclosing that it beneficially owned more than 9% of the outstanding stock of Amicus, and certified that the securities were not acquired and are not held for the purpose of or with the effect of changing or influencing the control of the issuer of the securities and were not acquired and are not held in connection with or as a participant in any transaction having that purpose or effect.

In April 2021, Perceptive began to discuss a potential transaction between Amicus and ARYA IV, and, on June 2, reached a non-binding agreement on terms of the potential transaction. The SEC alleges that "by June 2, 2021," Perceptive could not certify that the Amicus securities it held were held without control purposes, but that it did not file the required Schedule 13D until February 22, 2022.

On account of the alleged conduct, the SEC charged Perceptive with violations of Sections 206(2) and 206(4) of the Advisers Act, and Rules 206(4)-7 and 206(4)-8 thereunder, as well as Section 13(d) of the Exchange Act and Rule 13d-1 thereunder. Perceptive agreed to cease and desist from future violations, to be censured, and to pay a civil money penalty of $1.5 million.

The Perceptive Order serves as a reminder that conflicts of interest are a perennial focus of the SEC exam and enforcement staff, and the importance of carefully examining new and developing business practices for potential conflicts of interest.

SEC charges venture capital adviser for allegedly overcharging on management fees

On September 2, 2022, the SEC issued an order (EIC Order or the Order) instituting and settling administrative and cease-and-desist proceedings against Energy Innovation Capital Management, LLC (EIC), a California-based exempt reporting adviser. The Order arose out of EIC's alleged miscalculation, and resulting overcharges, of management fees for two venture capital funds.

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The Order alleges that, from January 2020 through March 2022, EIC made a number of errors in its management-fee calculation processes that resulted in overcharges. According to the Order, the limited partnership agreements of the relevant venture capital funds provided that management fees would be calculated based on committed capital during the "Commitment Period," but that during the "Post-Commitment Period" management fees would be calculated based on invested capital reduced by "dispositions" (as defined in the LPAs).

The SEC alleges that EIC made several errors in calculating management fees. These alleged errors included failing to account for write-downs, which should have been treated as "dispositions" during the Post-Commitment Period; incorrectly aggregating capital at the portfolio company level, rather than at the individual portfolio company security level, for fee calculations; incorrectly including accrued, but unpaid, interest in fee calculations; and incorrectly using a later date to begin the Post-Commitment Period (resulting in higher fees).

The SEC asserts that EIC collected $678,861 in excess management fees from the two funds and their limited partners. The EIC order notes that EIC returned this amount to the Funds after being contacted by SEC staff, and that the SEC considered EIC's "prompt remedial acts."

On account of the conduct described above, the SEC alleges that EIC violated Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder. EIC agreed to notify past and current fund investors of the settlement, to cease and desist from future violations, to be censured, and to pay a civil money penalty of $175,000.

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