

Investment Management Regulatory Update - January 2023

January 31, 2023 | Client Update | 6-minute read

In this issue we discuss, among other things, an update to SEC FAQs regarding compliance with the Advisers Act marketing rule, and a recent enforcement action involving a portfolio manager's failure to disclose an alleged conflict of interest.

Rules and regulations

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Rules and regulations

SEC proposes package of reforms to equity market structure rules

The Securities and Exchange Commission (SEC) recently proposed a set of sweeping equity market structure reforms across four rule proposals that would make highly significant changes to how national market system (NMS) stock orders are priced, executed and reported. The proposals include:

- a new requirement for certain retail orders to be subject to order-by-order competition, rather than being routed directly to market makers;
- an SEC-level best execution rule;
- an adjustment to the tick sizes at which NMS stocks can be quoted or traded; and
- a proposal to expand the scope and manner of execution information that is reported under Regulation NMS Rule 605.

For further information, please see our recent [client update](#) on this topic.

SEC staff updates FAQs regarding compliance with Advisers Act marketing rule

On January 11, 2023, SEC staff (the Staff) issued an update to [FAQs](#) (the FAQ) with responses to questions concerning the adoption of amendments to Rule 206(4)-1 (the New Marketing Rule) under the Investment Advisers Act of 1940 (the Advisers Act). In particular, the Staff clarified positions on the following questions, which are outlined in further detail below:

1. Whether Rule 206(4)-1(d)(1) under the Advisers Act (the Net Performance Requirement) requires that a registered investment adviser (RIA) display net performance alongside any presentation of gross performance for an individual investment (e.g., case study) or group of investments held by private funds that it advises; and
2. Whether, immediately after a calendar year-end, an RIA can use interim performance information to comply with the time period requirement under Rule 206(4)-1(d)(2) under the Advisers Act (the Prescribed Time Periods Rule), until it is able to calculate performance through such calendar year-end date.

Must an RIA display net performance alongside any presentation of gross performance for an individual investment (e.g., case study) or a group of investments held by a private fund that it advises?

According to the FAQ, the Net Performance Requirement requires RIAs to display net performance alongside any presentation of gross performance for individual investments (e.g., a case study) or groups of investments held by private funds that they advise. The FAQ also clarifies that the Staff will treat the performance of individual investments and groups of investments as examples of extracted performance.

Immediately after a calendar year-end date, can an RIA use interim performance information to calculate fund performance for the time periods prescribed under Rule 206(4)-1(d)(2), until it is able to calculate fund performance through such calendar year-end date?

The Prescribed Time Periods Rule, subject to certain exceptions, requires that performance results of a portfolio or aggregated portfolio be presented in one-, five- and 10-year periods (the Prescribed Periods), with each period ending on a date that is no less recent than the most recent calendar year-end date (the Calendar Year-End Requirement). The FAQ clarifies that if, immediately after a calendar year-end, an RIA is unable to calculate performance for the Prescribed Periods ending on such calendar year-end date, then the RIA may use current interim performance information (Interim Performance Information) (e.g., through Q3 for such calendar year) to make these calculations until it can comply with the Calendar Year-End Requirement. The Staff added that a “reasonable” period of time to calculate performance results based on the most recent calendar year-end generally would not exceed one month. The Staff also noted that any Interim Performance Information remains subject to other provisions of the New Marketing Rule.

Litigation

SEC settles charges against portfolio manager for an alleged conflict of interest relating to attempts to assist child’s film career

On January 5, 2023, the SEC issued an order (the Order) instituting and settling administrative and cease-and-desist proceedings against a former portfolio manager of a registered investment adviser (the Portfolio Manager) arising out of an alleged undisclosed conflict of interest. While conflicts of interest are a perennial focus of SEC concern, the Order arises out of an unusual alleged conflict: that a child of the Portfolio Manager had a role in a film distributed by a company in which the Portfolio Manager had recommended an investment.

Until 2020, the Portfolio Manager was one of three co-portfolio managers for a closed-end investment company that invested in fixed-income securities (the Fund). Beginning in 2014, the Portfolio Manager explored potential investments relating to “advertising expenses associated with film distribution,” and began discussions with a firm that sourced potential investments. In the course of those discussions, the Portfolio Manager allegedly asked that the sourcing firm assist the Portfolio Manager’s child with potential opportunities in the film industry.

According to the Order, the sourcing firm later introduced the Portfolio Manager to the principal of a film distribution company (the Principal) exploring opportunities to finance advertising expenses for films. The Portfolio Manager allegedly exchanged communications with the Principal regarding the film career and opportunities for the Portfolio Manager’s child; in the course of these communications, the Principal allegedly represented that he had the ability to influence casting decisions in films and could facilitate obtaining a film role.

The Order states that the Portfolio Manager recommended an investment in the Principal's film distribution company in 2015, and increased the size of that investment in 2017. In the summer of 2018, the Principal obtained a small film role for the Portfolio Manager's child. Later, in March 2019, the Principal contacted the Portfolio Manager to request \$10 million in funding to support the film's distribution. The Portfolio Manager allegedly directed another Fund employee to draft a synopsis predicting that without the funding, the distribution company would wind down and potentially reduce recoveries to the Fund, whereas making a \$10 million loan might improve recoveries on the Fund's investments. The SEC alleges that the Portfolio Manager did not disclose that the Portfolio Manager's child had a role in the film. The loan was ultimately approved and made, but not repaid. As a postscript, the Principal later pleaded guilty to two counts of wire fraud relating to, among other things, forging the signature of the Portfolio Manager on financing documents to remove liens securing the Fund's loans without the Fund's consent.

On account of this alleged conduct, the Portfolio Manager was charged with violations of Section 206(2) of the Advisers Act. The Portfolio Manager agreed to cease and desist from further violations, to be censured, and to pay a civil money penalty of \$250,000. (The Order also notes that the Portfolio Manager was terminated by his employer when the alleged conflict of interest came to light in preparation for civil litigation against the film distribution company.)

While a failure to disclose a child's role in a film may not be a routine basis for an Advisers Act enforcement action, the Order serves as an important reminder to conduct a broad and holistic assessment of potential conflicts of interest, including conflicts that may arise out of personal relationships rather than economic benefits — and to instruct adviser employees to obtain guidance when in doubt