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Investment Management Regulatory Update - June 2023

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In this issue, we discuss a risk alert relating to the Advisers Act Marketing Rule and recent enforcement actions regarding valuation and management fees.

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Industry update

SEC Examinations Division staff issues risk alert on additional areas of focus regarding the Advisers Act Marketing Rule

On June 8, 2023, the SEC's Division of Examinations staff (SEC staff) issued a risk alert that identified additional areas of review for examinations pertaining to Rule 206(4)-1 (Marketing Rule) under the Investment Advisers Act of 1940 (Advisers Act). The bulletin also restated the current areas of review when evaluating Marketing Rule compliance.

Restating the initial examination areas

The Risk Alert noted that when evaluating whether marketing materials of an investment adviser comply with the Marketing Rule, the SEC staff has been reviewing four initial subject areas. These subject areas were previously summarized in a Risk Alert published on September 19, 2022, and are as follows:

- **Policies and procedures**: evaluating whether advisers have adopted and implemented written policies and procedures that are reasonably designed to prevent violations by the advisers and their supervised persons of the Marketing Rule (and other provisions of the Advisers Act).
- **Substantiation**: evaluating whether advisers have a reasonable basis for believing they will be able to substantiate material statements of fact in their advertisements.

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- **Performance advertising**: evaluating whether advisers are in compliance with performance advertising requirements stipulated by the Marketing Rule.
- **Books and records**: evaluating whether advisers are in compliance with Advisers Act Rule 204-2, as amended, which requires advisers to maintain certain records, such as records of all advertisements they disseminate, including certain internal working papers, performance?related information, and documentation for oral advertisements, testimonials and endorsements.

Restating the general prohibitions

According to the Risk Alert, the SEC staff reviews 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.

Additional areas of review

The SEC staff identified additional areas of review when determining compliance with the Marketing Rule. While this list is not exhaustive, the new areas of review include the following:

If adviser advertising includes testimonials and endorsements, review of whether:

- Disclosures are provided, including clear and prominent disclosure of whether the person giving the testimonial or endorsement (promoter) is a client or investor, whether the promoter is compensated, and of material conflicts of interest.
- Oversight conditions are met, such as whether advisers have a reasonable basis for believing that the testimonials or endorsements disseminated comply with the requirements of the Marketing Rule.
- Written agreements are entered into, where required, such as written agreements with promoters, unless the promoters are applicable affiliates of the advisers and such affiliation is readily apparent or disclosed or the promoters receive de minimis compensation (i.e., $1,000 or less, or the equivalent value in noncash compensation, during the preceding 12 months).
- Ineligible persons have been compensated for testimonials or endorsements, if the adviser knew or reasonably should have known the person was ineligible, including certain "bad actors" that are prohibited from acting as promoters, unless such promoters meet the conditions for exemptions.

If adviser advertising includes third?party ratings:

- Review of whether the adviser provides, or reasonably believes that the third-party rating provides, clear and prominent disclosure of (i) the date on which the rating was given and the period of time upon which the rating was based; (ii) the identity of the third party that created and tabulated the rating; and (iii) if applicable, that compensation has been provided directly or indirectly by the adviser in connection with obtaining or using the third-party rating.
- Questionnaires or surveys used in preparation of a third-party rating must meet certain conditions, such as the adviser having a reasonable basis for believing that such questionnaire or survey is structured to make it equally easy for a participant to provide favorable and unfavorable responses and is not designed or prepared to produce any predetermined result.

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Finally, the SEC staff included a reminder that the Form ADV has been amended and requires investment advisers to provide additional information regarding their marketing practices. The SEC staff stressed that the information provided in the form will be reviewed for completeness and accuracy.

The SEC staff emphasized that investment advisers should reflect on their practices, policies and procedures to implement any appropriate modifications to their training, supervisory, oversight and compliance programs.

SEC Chair Gensler remarks before the Investment Company Institute

On May 25, 2023, SEC Chair Gary Gensler delivered remarks at the Investment Company Institute's 2023 Leadership Summit and discussed the risk of runs in money market funds and open-end funds, and recent SEC proposals.

Chair Gensler stated that runs "have brought down many a financial firm," and described how Congress adopted the Investment Company Act and Investment Advisers Act of 1940 in the wake of failures by investment trusts and investment companies. While Chair Gensler stated that the 1940 Acts and related SEC rules have lowered the risk of "financial fires" spreading from funds, he believes that risk related to fund dilution and liquidity remains, particularly in times of market stress. He highlighted investors' "dash for cash" at the onset of the COVID-19 pandemic, and the government's subsequent intervention. Chair Gensler then discussed SEC proposals that he said are intended to address structural issues and enhance liquidity risk management for both money market and open-end funds.

Chair Gensler stated that money market funds now stand at $5.8 trillion and could take a greater share with potential changes to the deposit and banking landscape. He noted that the SEC's proposed rule regarding money market funds would enhance liquidity requirements and prevent money market funds from imposing limits on redemptions in times of stress, such as so-called "gates." The proposal would also require institutional prime and tax-exempt money market funds to implement swing pricing or liquidity fees "to better address pricing and reduce dilution in times of stress."

Chair Gensler also discussed SEC proposals relating to the "liquidity, pricing, and plumbing" of open-end funds. He noted that the proposal would establish minimum standards for liquidity classifications, which he stated is designed to prevent funds from overestimating the liquidity of their investments. As to pricing, Chair Gensler noted that the SEC proposals put forward various alternatives within the framework of either swing pricing or liquidity fees, with the goal that "redeeming shareholders bear the appropriate costs associated with their redemptions, particularly in times of stress." Finally, the SEC has proposed to shorten the lag between when investors' orders are placed and when the fund receives those orders, which Chair Gensler stated can create vulnerabilities.

Additionally, Chair Gensler discussed related products – short-term investment funds and collective investment funds – that are overseen by bank regulators. He stated that rules for these funds lack, among other things, limits on illiquid investments and minimum levels of liquid assets, creating "regulatory gaps." Chair Gensler stated that the SEC is in discussions with bank regulators about these issues.

Chair Gensler concluded by reiterating the need to protect investors from fund dilution. Chair Gensler stated that it is about "getting back to what [President] Roosevelt and Congress were trying to address in 1940 – that funds are liquid to meet redemptions, and valuations appropriately reflect the prices of the underlying portfolio."

Litigation

SEC settles with investment adviser for allegedly deficient valuation policies and procedures

On May 24, 2023, the SEC issued an order (the Sciens Order) instituting and settling cease-and-desist proceedings against Sciens Investment Management, LLC (SIM) and Sciens Diversified Managers, LLC (SDI, and together with SIM, Sciens) for allegedly failing to adopt and implement reasonably designed policies and procedures for valuation of investments in the portfolios of its managed funds.

An affiliate of Sciens managed the Sciens Special Situations Master Fund Ltd. (SSSMF), a fund that pursued a strategy of investing in various classes of assets. The offering documents for SSSMF disclosed that Sciens would charge management fees measured by the net asset value of the applicable share class of SSSMF. The offering documents further disclosed that NAV would be calculated based on the total assets of the fund minus accrued debts, liabilities and obligations and contingencies, and that SSSMF would value its investments in a manner that it believed would reflect fair market value.

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As described in the Sciens Order, GAAP's valuation framework directs that the methods used to measure fair value "shall maximize the use of relevant observable inputs and minimize the use of unobservable inputs." It further characterizes as "Level 3" any inputs that are "unobservable inputs for the asset or liability." Such inputs are to be used when "observable inputs are not available."

The SEC alleges that Sciens' written policies and procedures did not sufficiently provide guidance or parameters on how to value investments for which observable inputs of value were not available even though virtually all of SSSMF's investments and a substantial percentage of its other managed funds' investments were of such type.

According to the Sciens Order, Sciens was on notice that its valuation procedures "may have been insufficient" because SSSMF's auditors provided qualified audit opinions due to the auditors' inability to obtain sufficient appropriate evidence supporting the fair value of a material investment. The auditor for SSSMF's 2016 financial statements allegedly later withdrew its audit opinion; after SSSMF restated its 2016 financial statements writing down the value of that investment by approximately $32.9 million, SSSMF's new auditor issued an unqualified opinion on SSSMF's 2016 financial statements. SSSMF then made retroactive adjustments to management fees accrued between 2016 and 2019 to account for the reduction to NAV.

On account of the conduct alleged, the SEC asserts that Sciens violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder. Sciens agreed to retain an independent compliance consultant, to cease and desist from future violations, to be censured and to pay civil money penalties of $275,000.

SEC settles with investment adviser for allegedly excessive management fees

On June 20, 2023, the SEC issued an order (the Insight Order) instituting and settling cease-and-desist proceedings against Insight Venture Management LLC (Insight), a New York-based investment adviser with approximately $79 billion under management as of December 2022. The Order alleges that Insight improperly calculated management fees attributable to impaired investment in its managed funds' portfolios.

According to the Insight Order, the limited partnership agreements (LPAs) of Insight's managed funds provided that management fees would be charged during post-commitment periods based on each investor's pro rata shares of the funds' invested capital. The LPAs further provided that if Insight determined that a portfolio investment had suffered a "permanent impairment," Insight would remove an amount equal to the difference between the acquisition cost and the impaired value from the fund's invested capital, which would reduce the basis upon which management fees were calculated.

The SEC alleges that Insight used a "four-pronged test" for impairment, under which it considered whether (i) a fund's aggregated investments in a portfolio company were written down in excess of 50% of the aggregate cost; (ii) if the valuation of the Fund's aggregated investments had been written down below its aggregate costs for six consecutive quarters; (iii) whether the write-down was primarily due to the portfolio company's weakening operating results as opposed to market conditions, comparable transactions or valuations of comparable companies; and (iv) whether the portfolio company would need to raise additional capital in the next 12 months.

In the SEC's view, Insight assessed impairment at the portfolio company level, not the portfolio investment level as was required by the fund LPAs, and thus failed to analyze whether each fund's investments in a portfolio company had been permanently impaired (as opposed to whether all investments in that company had been impaired in the aggregate). In addition, the SEC alleges that because Insight did not disclose its four criteria to investors, it did not disclose the conflict of interest present in Insight using subjective criteria to assess impairment – such as whether the portfolio company would need to raise capital in the next 12 months – which, in turn, would impact its fee income. As a consequence, the SEC further alleges that Insight failed to adopt or implement written policies or procedures reasonably designed to prevent violations relating to management fees and the associated conflict of interest.

The Insight Order notes that during an SEC examination, and before the SEC began an enforcement investigation, Insight adopted and disclosed new and more objective permanent impairment criteria, applied the revised criteria to four portfolio companies, and reimbursed the managed funds for management fees and interest relating to those companies in the amount of $3,821,032.32. The SEC also applied its prior criteria across all funds at the investment level, and reimbursed an additional $864,958.17 to the funds.

On account of this conduct, the SEC alleges that Insight violated Sections 206(2) and 206(4) of the Advisers Act, and Rules 206(4)-8 and 206(4)-7 thereunder. Insight agreed to pay disgorgement of $773,754.41, prejudgment interest of $91,203.76, and a civil money penalty of $1.5 million, and to be censured and to cease and desist from future obligations.

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As this publication has frequently noted, management fee calculation and allocation, and associated conflicts of interest, are a perennial focus of SEC exams and enforcement; this settlement serves as yet another reminder of the importance of accurate calculation and disclosures regarding management fees and associated conflicts of interest.

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