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# Investment Management & Funds Regulatory Update - September 2023

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In this issue, we discuss a risk alert issued by the SEC's Division of Examinations regarding investment adviser examinations, and recent enforcement actions involving advisers, conflicts of interest and alleged violations of the Marketing Rule with respect to hypothetical performance.

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## Rules and regulations

### SEC adopts new rules and amendments that increase private fund adviser regulation

In an August 23, 2023 release, the Securities and Exchange Commission (SEC) voted to adopt long-awaited new rules and amendments (Rule) under the Investment Advisers Act of 1940, as amended (Advisers Act). The Rule includes new requirements related to quarterly statements, private fund audits, adviser-led secondaries, restricted activities, preferential treatment and annual reviews under Rule 206(4)-7. For further information, please see our recent client update on this topic.

### SEC adopts amendments to Investment Company Act "names rule"

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In a September 20 release, the SEC adopted amendments to Rule 35d-1 (Names Rule) under the Investment Company Act of 1940, as amended (Investment Company Act), which addresses names of registered investment companies and BDCs that the SEC believes are likely to mislead investors about a fund's investments and risks. The amendments are designed to modernize and enhance the Names Rule, as well as related disclosure and reporting requirements, to further the SEC's investor protection goals and to address developments in the fund industry since the adoption of the Names Rule in 2001. For further information, please see our recent client update on this topic.

## SEC reopens comment period for proposed safeguarding rule

The SEC is reopening the comment period for its proposed safeguarding rule, which was first proposed on February 15, 2023. The proposed rule would replace current Rule 206(4)-2 (Custody Rule) under the Advisers Act, and would broaden the scope of the current Custody Rule by, among other things, expanding the type of assets that are subject to the rule (including explicitly covering crypto assets, whether or not securities), increasing the compliance burden for advisers, and imposing additional requirements for custodians to qualify as qualified custodians. The proposed safeguarding rule would also significantly enhance the role of qualified custodians used by advisers. The SEC noted that it is reopening the comment period until October 30, 2023 to allow additional time to assess the proposed amendments to the Custody Rule's audit provision in light of the recently adopted private fund adviser rule regarding private fund audits. For further information on the proposed safeguarding rule, please see our client update on this topic.

# Industry update

## SEC Division of Examinations issues Risk Alert regarding examination of investment advisers

On September 6, 2023, the staff of the SEC's Division of Examinations (Staff) issued a Risk Alert to highlight the Staff's considerations in determining the scope and focus of examinations.

**Background**

According to the Risk Alert, given that the population of SEC-registered investment advisers varies in organization size, business activity, size of assets under management and clientele, the Staff utilizes a risk-based approach for selecting advisers to examine and for determining the scope of risk areas to examine. The Staff's risk-based approach adapts to changes in market conditions, industry practices and investor preferences. The Risk Alert noted that the Staff reviews disclosure documents and regulatory filings, and leverages technology to analyze large sets of industry-wide and firm-level data to help identify risks and better understand an investment adviser's business.

**Selecting firms to examine**

Some of the reasons the Staff may select an adviser to examine include, but are not limited to, one or more of the following:

- The firm's risk characteristics, such as those relating to the investment adviser's business activities, conflicts of interest and regulatory history, including:
  - Prior examination observations and conduct (e.g., repetitive deficient practices, significant fee- and expense-related issues, significant compliance program concerns)
  - Supervisory concerns (e.g., disciplinary history of associated individuals or affiliates)
  - Business activities of the investment adviser or its personnel that may create conflicts of interest (e.g., outside business activities, dual registration as adviser and broker)
  - Length of time since the firm's registration or last examination
  - Material changes in a firm's leadership or other personnel
  - Indications that an adviser might be vulnerable to financial or market stresses
  - News or media reports involving or impacting the firm, and data provided by third-party services
  - Disclosure history of the firm

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- The firm's level of access to client and investor assets, and gatekeeper or service provider compliance risks

– A tip, complaint or referral regarding the firm
– The Staff's interest in a particular compliance risk area

**Selecting examination focus areas**

Once a firm is selected for examination, the Staff conducts a risk assessment to determine the scope of examination. The Risk Alert highlighted factors that guide the determination of such scope including: (i) the reason such firm was selected for examination, (ii) the firm's business model and (iii) the risks associated with such business model. While the scope of examinations will vary from examination to examination, the Staff noted that they typically include review of the investment adviser's operations, disclosures, conflicts of interest and compliance practices in core areas such as: custody and safekeeping of client assets, valuation, portfolio management, fees and expenses, and brokerage and best execution.

**Selecting documents to request**

The Staff noted that it typically sends a letter notifying the firm of an upcoming examination, which would include an initial information request list that would typically cover:

– General information on the adviser's business and investment activities
– Compliance risks that the adviser has identified, written policies and procedures adopted and implemented to address each of those risks
– Information to facilitate testing of advisory trading activities
– Information for the Staff to perform compliance testing in various areas

The Staff provided an example of a typical initial information request list as an attachment to the Risk Alert.

**Conclusion**

The Staff remarked that the Risk Alert is intended to aid investment advisers in preparing for an examination and may also provide helpful guidance for advisers' compliance efforts.

# Litigation

## The SEC's sweep exam into Marketing Rule violations results in charges against nine registered investment advisers over hypothetical performance advertising

On September 11, 2023, the SEC issued nine orders instituting and setting administrative and cease-and-desist proceedings (and a press release (the Press Release) summarizing these orders) announcing settled charges against nine registered investment advisers (RIAs). The Orders alleged that these nine RIAs advertised hypothetical performance—the hypothetical performance of a model portfolio back-tested against data from periods prior to the launch of the strategy in question—without adopting and implementing policies and procedures required by Rule 206(4)-1 (the Marketing Rule) under the Advisers Act.

**Hypothetical performance under the Marketing Rule**

The Marketing Rule prohibits RIAs from including hypothetical performance information in advertisements unless they adopt policies and procedures reasonably designed to ensure that the hypothetical performance is relevant to the likely financial situation and investment objectives of an advertisement's intended audience. Under the Marketing Rule, hypothetical performance includes performance results that were not actually achieved by any portfolio of an RIA, such as model performance, back-tested performance, and targeted or projected performance returns.

If an advertisement includes hypothetical performance information, the RIA must also disclose any underlying criteria and assumptions and risks and limitations associated with such information.

**The settlements**

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The SEC's orders found that each of the charged RIAs violated the Marketing Rule by advertising hypothetical performance information to mass audiences on their websites without having adopted and implemented the requisite policies, procedures and disclosures. The alleged hypothetical performance used in advertising included back-tested performance and the performance of model portfolios. In addition, two of the advisers failed to maintain required copies of their advertisements in contravention of Section 204(a) of the Advisers Act and Rule 204-2(a)(11) thereunder, which requires RIAs to keep a "copy of each" advertisement that the RIA disseminates, directly or indirectly.

Without admitting or denying any findings, all nine RIAs agreed to pay civil penalties ranging from $50,000 to $175,000, and, to the extent that they plan to disseminate advertisements containing hypothetical performance, to adopt and implement the required policies and procedures, and to provide written certification of such compliance with supporting evidence.

The nine settlements are part of the SEC's ongoing Marketing Rule sweep exam, the review areas for which are described in the SEC Division of Examinations' risk alert published on June 8, 2023. In the risk alert, the SEC Division of Examinations encourages RIAs to review their websites and other marketing materials for compliance with the Marketing Rule, "including ensuring that they have a reasonable basis for believing they will be able to substantiate material statements of fact and that their performance advertising, including extracted performance and hypothetical performance, complies with the requirements of the Marketing Rule." The disclosure of hypothetical performance may be an area of continued focus during sweep exams focused on Marketing Rule compliance. In the Press Release, SEC Division of Enforcement Director Gurbir S. Grewal emphasizes that "[b]ecause of their attention-grabbing power, hypothetical performance advertisements may present an elevated risk for prospective investors whose likely financial situation and investment objectives don't match the advertised investment strategy."

**Future enforcement action**

Director Grewal also refers to an "ongoing investigation" of potential Marketing Rule violations in the Press Release, which suggests that additional enforcement action may be forthcoming. RIAs should therefore review their policies and procedures to ensure that any hypothetical performance advertised on their websites is relevant to the likely financial situation and investment objectives of the intended audience of the advertisement.

## SEC settles with private equity manager for alleged breaches of fiduciary duty of care, conflicts of interest

On September 22, 2023, the SEC issued an order (the AIM Order) instituting and settling cease-and-desist proceedings against American Infrastructure Funds, LLC (AIM), a private equity investment adviser with approximately $1.3 billion in assets under management. AIM allegedly breached its fiduciary duty of care by accelerating a portfolio company monitoring fee without timely disclosure, by causing a fund to bear expenses that should have been borne by a different fund advised by an affiliated adviser, and by transferring an asset from one series of funds to another without adequate consent, effectively locking up investors for an additional 11 years.

As relevant to the AIM Order, AIM advised the "GEN I Funds," funds formed between 2005 and 2008, and the "GEN II Funds," funds formed between 2012 and 2013, as well as the "NABF" fund, formed in 2015.

In June 2008, the GEN I Funds invested in "Portfolio Company." At that time, Portfolio Company entered into a monitoring agreement with AIM, under which Portfolio Company paid AIM certain monitoring fees annually, which fees were offset against the management fees AIM would receive from the GEN I Funds. In August 2017, AIM entered into an amended monitoring agreement with Portfolio Company, under which Portfolio Company would pay AIM up to $4.5 million in accelerated fees if the agreement was terminated before the end of its 10-year term. AIM allegedly failed to disclose the potential conflict of interest this generated to the GEN I Funds. In February 2019, when AIM sold the Portfolio Company and terminated the monitoring agreement, AIM accelerated $4.5 million in monitoring fees.

The SEC alleges that AIM breached its duty of care by causing the fees to be accelerated because it failed to consider whether accelerating the fee was in the GEN I Funds' best interest, given that the majority of the GEN I Funds were no longer paying management fees to AIM at that time. The SEC further alleges that AIM could not consent to the receipt of the fees for the GEN I Funds because AIM did not adequately disclose the conflict of interest (i.e., the conflict between AIM's receipt of the accelerated fee and the impact of the fee on the value of Portfolio Company realized for the GEN I Funds).

From 2010 to 2015, the AIM Order states, GEN I Funds invested in a portfolio company that purchases and builds toll bridges. In June 2016, close to the end of the 10-year term of the GEN I Funds, AIM caused GEN I Funds' interests in this portfolio company to be transferred to NABF, which AIM managed and which would have a 12-year term; in exchange, the GEN I Funds received a limited partnership interest in NABF, as well as other commitments with respect

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to NABF.

The SEC alleges that the result of the transfer was to “lock up” investors in GEN I Funds for an additional 11 years (through the end of the 12-year term of NABF). According to the AIM Order, AIM did not disclose to GEN I Funds investors that their investment would be locked up beyond the original 10-year term of the GEN I Finds, that investors had no opportunity to object or to exit the investment, and that AIM would receive additional compensation from NABF as a result of the transfer, and failed to disclose the conflict of interest caused by the transaction.

Finally, between 2017 and 2018, the GEN II Funds allegedly incurred approximately $1.3 million in deal expenses in connection with an investment that the GEN II Funds did not pursue. In July 2018, a different fund managed by an affiliated adviser considered the investment, and reimbursed the GEN II Funds for those expenses. In January 2019, AIM allocated those expenses back to the GEN II Funds, and accounted for it as a liability that the affiliated fund owed to the GEN II Funds, effectively recognizing the fees as a loan from the GEN II Funds to the affiliated fund.

The SEC alleges that AIM breached its duty of care to the GEN II Funds by failing to determine whether the allocation of expenses was in the best interest of the GEN II Funds, and failed to disclose, or to seek guidance or an opinion regarding, the conflict of interest created by the loan between the GEN II Funds and the affiliated fund.

On account of this alleged conduct, the SEC charged AIM with violations of Sections 206(2) and 206(4) of the Advisers Act, and Rules 206(4)-8 and 206(4)-7 thereunder. AIM agreed to be censured, to cease and desist from future violations, and to pay disgorgement of $373,368 and prejudgment interest of $72,092, and a civil money penalty of $1.2 million. AIM also undertook to inform its investors of the order.

The AIM Order is yet another reminder that conflicts of interest remain a perennial focus of the SEC, and that acceleration of monitoring fees and allocation of deal expenses generated a large number of enforcement actions in 2015 and subsequent years. In addition, the AIM Order alleges and charges AIM with failing to implement its compliance policies and procedures without identifying any specific failure to implement or follow a relevant policy, suggesting (as written) that a compliance failure may be inferred from the fact of the alleged violations.

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