Davis Polk

Investment Management & Funds Regulatory Update - August 2024

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In this issue we discuss, among other things, amended reporting requirements for registered funds and SEC guidance regarding open-end fund liquidity risk management programs, as well as recent enforcement actions involving investment advisers.

Table of contents

Rule and regulations

SEC adopts reporting enhancements for registered investment companies and provides guidance on open-end fund liquidity risk management programs

The SEC's form and rule amendments require 1940 Act funds to enhance their reporting requirements. The SEC also provided guidance regarding liquidity risk management programs, addressing certain questions that have arisen since the implementation of the liquidity risk management rule.

On August 28, 2024, the Securities and Exchange Commission (SEC) adopted amendments (the Amendments) to reporting requirements on Forms N-PORT and N-CEN intended to provide the SEC and investors with more timely information about registered open-end funds, registered closed-end funds and exchange-traded funds organized as unit investment trusts (Covered Funds). The Amendments, once effective, will require more frequent filings of Form N-PORT and increased disclosure about liquidity service providers on Form N-CEN. On the same date, the SEC provided guidance on open-end fund liquidity risk management programs, including information regarding certain questions that have arisen since the adoption of the initial rule. Such guidance relates to: (i) the frequency of classifying the liquidity of fund investments, (ii) the meaning of "cash" in the liquidity rule, and (iii) determining and reviewing the highly liquid investment minimums.

- Amendments to Form N-PORT and Rule 30b1-9
  - Covered Funds will be required to file Form N-PORT reports on a monthly, rather than a quarterly, basis.

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    - Covered Funds will be required to make such monthly filings within 30 days after the end of the month to which they relate, rather than the previous requirement of within 60 days after the end of the relevant fiscal quarter.
    - The SEC will make public Form N-PORTs within 60 days of the end of each month.
    - Covered Funds will no longer be required to maintain records of this monthly information within 30 days of month-end.

- Amendments to Form N-CEN
    - Covered Funds that are subject to Rule 22e-4 will be required to identify and provide certain information about service providers that such funds use to fulfill the requirements of the rule. Such information includes:
        - The name of each liquidity service provider.
        - Identifying information, including the legal entity identifier (if available) and location, for each liquidity service provider.
        - Identification of whether the liquidity service provider is affiliated with the fund or its investment adviser.
        - Identification of the asset classes for which the liquidity service provider provided classifications.
        - Identification of whether the service provider was hired or terminated during the reporting period.

- SEC guidance on open-end fund liquidity risk management program requirements
    - The SEC noted that with respect to the requirement to consider intra-month changes in investment-specific considerations, open-end funds should:
        - Generally consider reviewing liquidity classifications if changes in portfolio composition are reasonably expected to materially affect one or more investment classifications. For example, the SEC noted that a fund that substantially increases the size of its position in an investment may reasonably anticipate trading a larger size of such investment, which could consequently affect the liquidity classification of such investment if a lack of market depth for a larger trade size makes it difficult to sell such investment within a specific time without such sale causing a significant change in the market value.
        - Generally consider classifying newly acquired investments intra-month if acquiring a particular investment is reasonably expected to result in material changes to the liquidity profile of the fund, particularly "changes to the fund's liquidity profile that may cause a shortfall below a fund's highly liquid investment minimum or cause the fund to exceed the rule's limit on illiquid investments."
    - The SEC further noted that in determining when an investment can be "converted to cash," open-end funds carrying non-U.S. dollar currency investments should:
        - Consider reasonable expectations of the period of time it would take to convert a reasonably anticipated trade size of that currency into U.S. dollars under current market conditions without significantly changing the currency exchange rate. Factors to consider include: (i) the presence of currency controls, (ii) the presence of an active market in forward or spot contracts exchanging the currency for U.S. dollars, and (iii) any delays in currency conversions driven by market structure of operations.
        - Consider the: (i) reasonable expectations of the period of time in which an international non-currency investment can be sold and settled in the local market without significantly changing the market value of the investment, and (ii) reasonable expectations of the period of time in which any international currency received upon settlement can be converted to U.S. dollars without significantly changing the currency exchange rate. For example, the SEC noted that if a fund reasonably expects (i) that it could sell and settle a reasonably anticipated trade size of an international investment within three (3) business days without significantly changing the market value of the investment under the first consideration, and (ii) that the international currency it would receive upon settlement could be converted into U.S. dollars within the same three (3) business days without significantly changing the currency exchange rate under the second consideration, it would be reasonable for the fund to classify the international investment as highly liquid. Additionally, the SEC noted that if a fund converts an illiquid international investment into an illiquid local currency, and takes reasonable steps to convert the illiquid currency into U.S. dollars or invests in investments convertible into U.S. dollars, in an effort to reduce such fund's illiquid investments, the SEC would likely not consider the acquired illiquid currency to be in violation of the rule's prohibition on acquiring illiquid investments in excess of the rule's 15% limit.

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  - If a fund does not reasonably expect to be able to convert the local currency into U.S. dollars within seven calendar days because of currency controls or otherwise, the local currency should be classified as an illiquid investment.

- As noted in the SEC guidance, in determining its highly liquid investment minimum, a fund that does not primarily hold assets that are highly liquid investments should:
  - Consider its particular risk factors, and consider establishing a higher highly liquid investment minimum than a comparable fund that is more liquid.
  - Consider the volatility of its investment strategies, especially with respect to funds that have had greater volatility in reasonably foreseeable circumstances.
  - Consider the SEC's general belief that liquidity risk management is better conducted primarily through construction of a fund's portfolio, rather than by use of a line of credit or similar arrangement.

The effective date of the amendments to Form N-PORT and N-CEN is November 17, 2025, with smaller entities having an extended compliance period, for the Form N-PORT amendments, until May 18, 2026.

FinCEN issues final rule for investment advisers regarding anti-money laundering and countering the financing of terrorism programs

On August 28, 2024, the U.S. Department of the Treasury's Financial Crimes Enforcement Network (FinCEN) issued a final rule regarding anti-money laundering and countering the financing of terrorism (AML/CFT) programs applicable to certain registered investment advisers and exempt reporting advisers. The rule requires, among other things, certain minimum standards for risk-based and reasonably designed AML/CFT programs to be implemented by such advisers, and requires such advisers to report suspicious activity to FinCEN. The compliance date for the rule is January 1, 2026. Davis Polk will publish a client update with further information on this topic shortly.

SEC adopts rule to adjust for inflation the dollar threshold in the definition of "qualifying venture capital fund"

In an August 21, 2024 release (Adopting Release), the SEC announced the adoption of new Rule 3c-7 under the Investment Company Act to adjust for inflation the definition of a "qualifying venture capital fund." Section 3(c)(1) of the Investment Company Act excludes a "qualifying venture capital fund" with not more than 250 security holders from the definition of an "investment company," and defines "qualifying venture capital fund" as "a venture capital fund that has not more than $10,000,000 in aggregate capital contributions and uncalled committed capital." In order to account for inflation, Rule 3c-7 updates the dollar threshold to $12,000,000 of aggregate capital contributions and uncalled commitment capital, referencing the Personal Consumption Expenditures Chain-Type Price Index (PCE Index).

Additionally, Rule 3c-7 provides that the dollar threshold for qualifying venture capital funds shall be adjusted for inflation by order of the SEC every five years, using the PCE Index to calculate inflation adjustments.

Final Rule 3c-7 will become effective September 30, 2024.

Litigation

SEC settles with investment adviser for alleged failure to comply with the Custody Rule

On August 19, 2024, the SEC issued an order (the FPA Order) instituting and settling administrative and cease-and-desist proceedings against FPA Real Estate Advisers Group, LLC (FPA), a California-based registered investment adviser with approximately $5.66 billion of assets under management. FPA allegedly violated Rule 206(4)-2 under the Advisers Act (the Custody Rule) by, among other things, failing to timely deliver audited financial statements of its pooled investment vehicles to investors, and failing to implement policies and procedures relating to the use of affiliated service providers.

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According to the FPA Order, from October 2019 through November 2022, FPA advised certain privately offered pooled investment vehicles, organized into master-feeder arrangements in which the master fund invested in real estate assets. During this time period, FPA disclosed in its Form ADV Part 1A that seven feeder funds were subject to an annual audit and that the audited financial statements for the most recent year were distributed to fund investors. However, FPA allegedly failed to obtain such audits and timely distribute the audited financial statements to investors as required under the Custody Rule.

Under the Custody Rule, certain of the rule's enumerated requirements can be satisfied with respect to a pooled investment vehicle by obtaining an annual audit for such pooled investment vehicle and distributing audited financial statements to its investors within 120 days of the end of the pooled investment vehicle's fiscal year. By allegedly failing to obtain the required annual audits and distribute audited financial statements to investors in the seven feeder funds, FPA allegedly violated the Custody Rule.

FPA also allegedly used two affiliates to provide management and construction services with respect to real estate assets owned by FPA's managed funds. FPA disclosed to investors that it used these affiliates and that the fees would be at market rates, but also disclosed that the fees paid to affiliates would be "lower or comparable" to those charged in arm's-length transactions with third parties. While FPA allegedly adopted written policies and procedures requiring annual or more frequent review of these fees to ensure they were at or below market rates, FPA allegedly failed to perform these reviews.

On account of this conduct, the SEC alleged that FPA violated Section 206(4) of the Advisers Act and Rules 206(4)-2 and 206(4)-7 thereunder. FPA agreed to be censured, to cease and desist from further violations, and to pay a civil money penalty of $300,000.

SEC settles with investment adviser for alleged pay-to-play violations arising out of a new hire's imputed contacts

On August 19, 2024, the SEC issued an order (the Obra Order) instituting and settling administrative and cease-and-desist proceedings against Obra Capital Management, LLC (Obra), a registered investment adviser based in Austin, Texas, with approximately $2.7 billion in assets under management.

According to the Obra Order, in 2017, the Michigan Department of the Treasury invested approximately $100 million in a fund managed by Obra. Later, in December 2019, an individual not affiliated with Obra at that time made a $7,150 campaign contribution to a Michigan government official. Later, in July 2020, Obra hired that individual into a role in which the individual became a "covered associate" of Obra.

Under Advisers Act Rule 206(4)-5, often called the "pay-to-play" rule, a campaign contribution triggers a "look back" provision, under which campaign contributions made within two years before a person becomes a "covered associate" of an adviser are subject to the pay-to-play rule's prohibitions. While there is an exception for certain returned contributions, that exception requires that the contribution in question cannot exceed $350 and that return must be sought within 60 days after the adviser learns of the contribution. A campaign contribution covered by the rule triggers a two-year "time out" during which the adviser cannot receive compensation for providing advisory services to the relevant government entity.

Here, after the individual was hired by Obra, the individual solicited and obtained a return of the contribution. The government official to which the individual had made the contribution had the ability to influence the hiring of investment advisers; Obra continued to provide investment advisory services for Michigan, thus violating the prohibition on receiving compensation for advisory services within two years of providing a covered campaign contribution.

On account of this conduct, the SEC alleged that Obra violated Section 206(4) of the Advisers Act and Rule 206(4)-5 thereunder. Obra agreed to be censured, to cease and desist from further violations, and to pay a civil money penalty of $95,000.

The Obra Order is a vivid reminder of the fact that campaign contributions made before a person becomes associated with an adviser may be imputed to the adviser, and that return of the contribution will not exempt the adviser from the strictures of the pay-to-play rules if the contribution exceeds the $350 limit or is not returned within the requisite time.

SEC settles with investment adviser for allegedly providing hypothetical performance information in violation of the Marketing Rule

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On August 9, 2024, the SEC issued an order (the Pacific Order) instituting and settling administrative and cease-and-desist proceedings against The Pacific Financial Group, Inc. (Pacific), a Bellevue, Washington-based registered investment adviser with approximately $3.7 billion in assets under management. Pacific allegedly published advertisements to the general public that contained hypothetical performance information in violation of Rule 206(4)-1 under the Advisers Act (the Marketing Rule).

Under the Marketing Rule, registered investment advisers are prohibited from including hypothetical performance information in their advertisements unless, among other things, the adviser adopts and implements procedures reasonably designed to ensure that the hypothetical performance is relevant to the likely financial situation and investment objectives of the intended audience of the advertisement.

According to the Pacific Order, Pacific allegedly presented hypothetical performance information—in the form of performance derived from model portfolios—on its website to the general public, rather than to a particular intended audience. According to the Pacific Order, Pacific failed to adopt and implement policies "reasonably designed to ensure the performance was relevant to the likely financial situation and investment objections of the intended audience."

On account of this conduct, the SEC alleged that Pacific violated section 206(4) of the Advisers Act and Rule 206(4)-1(d) thereunder. Pacific agreed to ensure compliance with the Marketing Rule, to cease and desist from further violations, to be censured, and to pay a civil money penalty in the amount of $430,000.

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