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AN OVERVIEW OF THE INVESTMENT ADVISERS ACT OF 1940©

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I. INTRODUCTION

The Investment Advisers Act of 1940, as amended ("Advisers Act" or "Act") is the last in a series of federal statutes intended to eliminate abuses in the securities industry that Congress believed contributed to the stock market crash of 1929 and the resulting Great Depression. It was enacted in conjunction with the Investment Company Act of 1940, as amended ("Company Act") and supplements other federal statutes regulating the securities industry by requiring the registration of certain "investment advisers" with the U.S. Securities and Exchange Commission ("SEC" or "Commission"). The Advisers Act was based on a Congressionally mandated study of investment trusts and investment companies, including consideration of investment counsel and investment advisory services, carried out by the SEC during the 1930's.[1] The Commission's report traced the historical growth of the advisory industry and stressed that a significant problem in the industry was the existence, either consciously or subconsciously, of a prejudice by advisers in favor of their own financial interests. The Act reflects congressional recognition of the "delicate" fiduciary nature of the advisory relationship, as well as Congress's desire to eliminate, or at least expose, all conflicts of interest which might cause advisers, whether intentionally or not, to render advice which is not disinterested.[2]

In 1996, Congress enacted the National Securities Market Improvement Act of 1996 ("NSMIA"),[3] which significantly altered the national regulatory scheme for investment advisers by dividing regulatory jurisdiction, in most respects, between the SEC and the states. That statute subjected to SEC registration investment advisers having over $25 million in assets under management ("AUM") and certain other categories of advisers as to which there is a national regulatory concern. Smaller investment advisers were expected to comply with the registration and regulatory requirements of the states in which they do business. This division of authority was revisited in 2010 when Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"),[4] which, among other things, significantly amended the registration requirements and exemptions previously available to certain investment advisers. In addition to repealing a long-standing registration exemption for private advisers, Dodd-Frank authorized the SEC to adopt and implement certain rules and regulations regarding newly enacted registration exemptions and requirements.

This outline discusses, in summary form, obligations imposed upon investment advisers under the federal securities laws, as well as the division of regulation between the SEC and the states. It does not describe every requirement to which an investment adviser may be subject and **cannot be relied upon as legal advice**. For example, it does not discuss fiduciary duties under the Company Act, or investment restrictions in such statutes as the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), the Bank Holding Company Act, the Federal Communications Act or other federal statutes. Nor does it cover the requirements of organizations such as the CFA Institute and its performance presentation requirements applicable to member firms. The outline is general in nature, requiring reference to applicable statutes, regulations and forms for more complete information to ensure compliance. Specific activities or events

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1 *See* Investment Trusts and Investment Companies, Report of the Securities and Exchange Commission. Pursuant to Section 3Q of the Public Utility Holding Company Act of 1935, on Investment Counsel Investment Management Investment Supervisory and Investment Advisory Services, H.R. Doc. No. 477, 76th Cong., 2d Sess. (1939).

2 *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191-92 (1963).

3 *See* Pub. L. No. 104-290, 110 Stat. 3416 (1996), codified in various sections of 15 U.S.C. 78a (2000).

4 *See* Pub. L. No. 111–203, 124 Stat. 1376, 1571 (2010).

require advice tailored to the particular circumstances involved which, in some cases, might make the principles discussed in this outline inapplicable.

II. INVESTMENT ADVISER UNDER THE ACT

Advisers Act Section 202(a)(11) defines the term "investment adviser" to mean:

> any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as a part of a regular business, issues or promulgates analyses or reports concerning securities . . . .

The staff of the SEC's Division of Investment Management ("Staff")—which administers the Act —has provided guidance regarding the three primary elements of the statutory definition and their applicability to persons, including financial planners, pension consultants and others, who provide investment advisory services to clients. To be an investment adviser under the definition, a person must satisfy **all** three elements, which are discussed separately below.[5]

A. "Compensation"

The term "compensation" is construed broadly. The receipt of any economic benefit, whether in the form of an advisory fee, some other fee relating to the total services rendered, a commission, or some combination thereof, satisfies this element. A separate fee for advisory services is not necessary. This element is satisfied if a single fee is charged for a number of services, including advisory services, such as a legal fee.[6]

B. "In the Business"

A person must also be in the "business" of providing investment advice for compensation to be deemed an investment adviser. This need not be the person's sole or principal business. There is no hard and fast standard for satisfying this element; it depends upon the degree of the person's advisory activities. The Staff views three criteria as relevant to this determination:

- Is the person giving investment advice solely incidental to his non-advisory business?
- How specific is the advice?
- Does the person receive compensation, whether directly or indirectly?

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[5] Most interpretations are in the form of Staff "no-action" letters. In addition, the Staff has issued two releases interpreting and summarizing its positions with respect to persons held to be within the definition of "investment adviser." *See* Applicability of the Investment Advisers Act to Financial Planners, Release No. IA-770 (Aug. 13, 1981) [hereinafter "Release 770"]; *see also* Applicability of the Investment Advisers Act of 1940 to Financial Planners, Pension Consultants, and Other Persons Who Provide Others with Investment Advice As a Component of Other Financial Services, Release No. IA-1092 (Oct. 8, 1987) [hereinafter "Release 1092"].

[6] *See* Milton O. Brown, P.C., SEC No-Action Letter (Aug. 29, 1983).

To distinguish a person "in the business" of providing advice from one who provides advice incidental to another business, SEC Release 770 provides the following guidance:

- A person who holds himself out to the public as an investment adviser or as one who provides investment advice is in the business of providing investment advice.
- A financial planner is providing investment advice if, on anything other than rare and isolated instances, he discusses the advisability of investing in specific securities or types of securities.
- A market timing service is an investment advisory business.

C. "Advice about Securities to Others"

A person clearly meets this element of the statutory definition by providing advice about, or issuing reports concerning, specific securities. The more difficult questions arise with less specific advice. The Staff takes the position that a person is an investment adviser if that person provides generalized advice about investing in "types" or "classes" of securities or investments (e.g., mutual funds, limited partnerships, bonds, equity securities) for compensation. The Staff has also stated:

- advice about market trends is advice about securities;[7]
- advice in the form of statistical or historical data generally is advice about securities unless the advice is no more than an objective report of facts on a non-selective basis;[8]
- advice about the selection of an investment manager may meet this element;[9]
- advice concerning the advantages of investing in securities versus other types of investments (e.g., real estate, coins, stamps) is advice about securities; and
- providing clients with a selective list of securities is advice about securities even though no specific recommendation is made from the list.

In addition, persons providing advice about securities must provide such advice to ***others***. For example, the SEC Staff has stated in no-action letters that it would not recommend enforcement action against certain subsidiaries that provide investment advice solely to their parent company and its wholly owned affiliates since the advisory subsidiary did not hold itself out publicly as an investment adviser and was not providing advice about securities to others.[10]

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[7] *See* Dow Theory Forecasts, Inc., SEC No-Action Letter (Feb. 2, 1978).

[8] *See* Bridge Data Co., SEC No-Action Letter (May 31, 1975).

[9] *See* FPC Securities Corp., SEC No-Action Letter (Dec. 1, 1974); *see also* Release 770.

[10] *See*, *e.g.,* Zenkyoren Asset Management of America Inc., SEC No-Action Letter (Jun. 30, 2011); Allianz of America, Inc., SEC Staff No-Action Letter (May 25, 2012); MEAG MUNICH ERGO Asset Management GmbH, SEC No-Action Letter (Feb. 14, 2014); and Lockheed Martin Investment Management Co, SEC No-Action Letter (Jun. 5, 2006).

A frequent question arising under the definition of "investment adviser" relates to individuals known as "financial planners." SEC Releases 770 and 1092[11] identify most financial planners as investment advisers under the Act who must comply with it unless they can rely on a statutory exception or exemption, as discussed below.[12]

III. EXCEPTIONS FROM THE "INVESTMENT ADVISER" DEFINITION

Subsections (A)-(H) of Section 202(a)(11) *except* various categories of persons who otherwise arguably satisfy the definition of "investment adviser", but for whom Congress has determined that regulation under the Act is unnecessary. If a person falls within any of the exceptions, **no** provisions of the Act apply (in contrast with the treatment afforded persons who are exempted from SEC registration, but not from the antifraud provisions of the Act). A person relying on an exception must meet all the requirements of the exception. The availability of any exception necessarily depends on the particular facts and circumstances involved. The exceptions are summarized below:

A. Any Bank or Bank Holding Company

Subsection 202(a)(11)(A) excepts a bank, or any bank holding company (as defined in the Bank Holding Company Act) which is not an investment company (but not a non-bank subsidiary of a bank holding company). However, the term "investment adviser" does include any bank or bank holding company that serves or acts as an investment adviser to a registered investment company. If such services or actions are performed through a separately identifiable department or division, the department or division, and not the bank itself, shall be deemed to be the investment adviser.

The term "bank" is defined in Advisers Act Section 202(a)(2) as:

- a banking institution organized under the laws of the United States;
- a member bank of the Federal Reserve System; and
- any other banking institution or trust company meeting the following four requirements:
    - doing business under the laws of any state or of the United States;
    - a substantial portion of the business of which consists of receiving deposits or exercising fiduciary powers similar to those permitted to national banks;

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[11] Release 1092 was issued jointly by the SEC and the North American Securities Administrators Association ("NASAA"), which represents the state regulatory authorities who administer state adopted investment adviser laws. By jointly issuing Release 1092, NASAA formally adopted the views expressed in Release 770 on the applicability of the state advisers' laws to financial planners. Therefore, an adviser doing business in a state having a state advisers' law must register either under the Act or, if ineligible for or exempt from SEC registration, with the state(s) unless also exempt from state registration. *See* Advisers Act Section 203A; NSMIA. Under Dodd-Frank, advisers required to register in 15 or more states are permitted to register with the SEC even if not otherwise eligible for SEC registration. *See* Dodd-Frank Section 410, 124 Stat. at 1576 (amending Advisers Act Section 203A(a) by inserting a new paragraph (2) which, among other things, revised from $25 million to $100 million the AUM threshold for federal registration, but included an exception for multi-state advisers).

[12] The Staff generally no longer issues no-action letters concerning the applicability of the Act to financial planners. *See* Mary E. Rogers, SEC No-Action Letter (May 20, 1982).

- supervised and examined by state or federal bank regulators; and
- not operated for the purpose of evading the Act, *or* any receiver or other liquidating agent of any institution listed above.

On several occasions, the Staff has addressed this exception, finding that:

- A foreign bank is not within the exception.[13]
- An investment adviser subsidiary of a bank holding company is not a "bank holding company" within this exception.[14]
- A savings and loan association is not a bank under the Act.[15]
- A Panamanian trust company is not within the exception.[16]

The SEC proposed to exempt certain thrift institutions from the definition of "investment adviser" when providing investment advice as part of certain trust department fiduciary services and to exempt thrift institutions' collective trust funds from the registration and reporting requirements of the Securities Exchange Act of 1934, as amended ("1934 Act").[17] However, no further action has been taken on these proposals.

B. Any Lawyer, Accountant, Engineer, or Teacher

Subsection 202(a)(11)(B) excepts four classes of professionals, as long as they provide investment advice solely incidental to the practice of their profession. The Staff considers the following factors in determining whether the advice provided is solely incidental to the professional work:

- Does the person hold himself out to the public as an adviser or financial planner or as providing pension consulting or other financial advisory services — if so, the exception is not available.[18]
- Any advisory services rendered must be reasonably related to professional activities.

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[13] *See* Letter to Congressman Williams J. Hughes, SEC No-Action Letter (Jun. 4, 1980). This result is highlighted by a 2013 settled SEC enforcement action against a Brazilian bank in which the bank was found to have violated the federal securities laws by providing advisory and brokerage services to at least 71 U.S. resident customers through their foreign bank accounts without registering as either an investment adviser or broker-dealer. *See* Banco Comercial Portugês, S.A., Release Nos. 33-9393, 34-69167, IA-3568 (Mar. 18, 2013).

[14] *See* William Casey, SEC No-Action Letter (Jun. 1, 1974).

[15] *See* Ameriway Savings Ass'n, SEC No-Action Letter (Apr. 28, 1986).

[16] *See* Brewer-Burner & Assocs., Inc., SEC No-Action Letter (Feb. 7, 1974).

[17] *See* the proposed rule, Certain Thrift Institutions Deemed Not to Be Investment Advisers, Release Nos. 34-49639, IA-2232 (Apr. 30, 2004) (proposing Advisers Act Rule 202(a)(11)-2 and 1934 Act Rule 240.12g-6).

[18] *See, e.g.*, Release 770; LaManna & Hohman, SEC No-Action Letter (May 21, 1983) (accountant); Mortimer M. Lerner, SEC No-Action Letter (Feb. 15, 1980) (lawyer).

- Any charge for advisory services should be based on the same factors that determine the professional's usual charges.

C. Any Broker or Dealer

Subsection 202(a)(11)(C) excepts any broker-dealer who provides investment advice solely incidental to the conduct of its business as a broker-dealer *and* who receives no special compensation for such advice. Most questions under this exception concern what is "special compensation." In 1985, a Staff no-action letter discussed "special compensation" at length,[19] concluding that brokerage commissions generally would not constitute special compensation unless a clearly definable part of the commission is for investment advice. The Staff also stated that the exception is:

- available to any registered representative of a broker who provides investment advice in that capacity, e.g., the registered representative provides advice in his capacity as a supervised employee of his employer broker-dealer; and

- not available to any registered representative acting as a financial planner outside of the scope of his employment with his broker-dealer employer.

The registered representative also must be subject to control by his employer broker-dealer and must be providing investment advice with the knowledge and approval of his employer.[20] As for what constitutes "control," the Staff has stated that the presumption that an independent contractor cannot be subject to the control of its employer is incorrect in the context of the 1934 Act. Furthermore, the Staff has stated that where a firm forms a relationship with an independent contractor, the firm must assume supervisory responsibility for the contractor or else ensure that the contractor is registered.[21]

In 2005, the SEC adopted Rule 202(a)(11)-1 under which broker-dealers who engaged in certain activities such as discretionary management of client accounts or financial planning would not be deemed to be "investment advisers" within the meaning of the Act even where special compensation might be deemed to exist.[22] The Staff issued a related no-action letter[23] clarifying, among other things, when and how the rule applied to dual registrant[24] broker-dealers. On March 30, 2007, the rule was vacated by a federal circuit court.[25] No appeal was filed.

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[19] *See* Robert S. Strevel, SEC No-Action Letter (Apr. 29, 1985).

[20] *See* Elmer D. Robinson, SEC No-Action Letter (Jan. 6, 1986); Brent A. Neiser, SEC No-Action Letter (Jan. 18, 1986).

[21] *See* Letter from Douglas Scarff, Dir., Div. of Market Regulation, SEC, to Gordon S. Macklin, President, Nat'l Ass'n of Sec. Dealers, Inc. (Jun. 18, 1982).

[22] *See* Certain Broker-Dealers Deemed Not to Be Investment Advisers, Release Nos. 34-51523, IA-2376 (Apr. 12, 2005).

[23] *See* Securities Indus. Ass'n, SEC No-Action Letter (Dec. 16, 2005). Under the letter, a dual registrant who provides financial planning services to a client could discontinue its advisory relationship with its client and then assume a brokerage relationship as long as the client was provided full disclosure about the change in the relationship and any consequent change in the obligations assumed by the broker-dealer, clearly indicating that the dual registrant was removing itself from a position of trust and confidence with respect to the client.

[24] "Dual registrants" as used herein means registered investment advisers who are also registered broker-dealers.

[25] *See Financial Planning Ass'n v. SEC*, 482 F.3d 481 (D.C. Cir. 2007) (vacating Rule 202(a)(11)-1 on grounds that SEC lacked authority to except broker-dealers offering fee-based brokerage accounts from "investment adviser" definition).

Instead, the SEC issued revised Proposed Rule 202(a)(11)-1,[26] which, if adopted, would re-codify two interpretations associated with the vacated rule regarding what constitutes activity that is not "solely incidental to brokerage services" for purposes of Subsection 202(a)(11)(C). The proposed rule would clarify that a registered broker-dealer: (a) provides investment advice that is not "solely incidental to" its business as a broker-dealer if it exercises investment discretion (other than on a temporary or limited basis) with respect to an account or charges a separate fee, or separately contracts, for advisory services; (b) does not receive special compensation solely because it charges different rates for full-service versus discount brokerage services; and (c) may limit advisory accounts to those which involve services or compensation subjecting it to the Act. No further action has been taken on this proposal.

Section 913 of Dodd-Frank directed the SEC to study, evaluate and report to Congress on "the effectiveness of existing legal or regulatory standards of care for brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers for providing personalized investment advice and recommendations about securities to retail customers" and whether "there are legal or regulatory gaps, shortcomings, or overlaps in legal or regulatory standards in the protection of retail customers relating to the standards of care for brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers for providing personalized investment advice about securities to retail customers that should be addressed by rule or statute."[27] The SEC's study report was sent to Congress in January 2011.[28]

The report concluded that "Despite the extensive regulation of both investment advisers and broker-dealers, retail customers do not understand and are confused by the roles played by investment advisers and broker-dealers, and more importantly, the standards of care applicable to investment advisers and broker-dealers when providing personalized investment advice and recommendations about securities." As a result, the report recommended that the SEC "exercise its rulemaking authority to adopt and implement, with appropriate guidance, the uniform fiduciary standard of conduct for broker-dealers and investment advisers when providing personalized investment advice about securities to retail customers."

Dodd-Frank Section 913 also directed the SEC to consider "the potential impact of eliminating the broker and dealer exclusion from the definition of 'investment adviser' under" the Advisers Act. In addition, Dodd-Frank authorized the SEC to adopt rules under both 1934 Act Section 15 and Advisers Act Section 211 to provide "that the standard of conduct for all brokers, dealers, and investment advisers, when providing personalized investment advice about securities to retail customers (and such other customers as the Commission may by rule provide), shall be to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice." On March 1, 2013, the SEC issued a release requesting data and information on this topic, which included a six-month comment period from the date of publication in the Federal Register.[29] The Investment Adviser Association ("IAA") and others have urged the SEC to extend to all broker-dealers, who offer personalized investment advice about securities to retail customers, the same fiduciary duty applicable to advisers.[30] In 2019, the SEC

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[26] *See* Interpretive Rule under the Advisers Act Affecting Broker-Dealers, Release No. IA-2652 (Sep. 24, 2007).

[27] 124 Stat. at 1824, Section 913 ("Study And Rulemaking Regarding Obligations of Brokers, Dealers, and Investment Advisers").

[28] SEC, Study on Investment Advisers and Broker-Dealers As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (2011).

[29] *See* Duties of Brokers, Dealers, and Investment Advisers, Release Nos. 34-69013, IA-3558 (Mar. 1, 2013).

[30] *See* Letter from Consumer Fed'n of America et al., to SEC Chair Mary Schapiro (Mar. 28, 2012).

ultimately adopted Regulation Best Interest ("Reg. BI"), which applies a best interest obligation to broker-dealers making securities recommendations to certain types of retail customers.

As noted above, registered broker dealers who provide such research to clients often rely on an exception from the definition of "investment adviser" under the Advisers Act, which requires that (i) investment advice is "solely incidental" to the broker dealer's business, and (ii) the broker-dealer may not receive "special compensation."[31] On January 3, 2018, the European Union's Markets in Financial Instruments Directive II ("MiFID II") came into effect, which required that certain firms separate charges for investment research. Where traditionally investment research was bundled within commission payments, the MiFID II required that investment research be charged separately from other services. This change qualified such charges for the investment research as "special compensation" for investment advice—which would prevent the broker-dealer from using the exception from qualifying as an investment adviser under Subsection 202(a)(11)(c) of the Advisers Act. Prior to MiFID II taking effect, the Staff issued a no-action letter providing temporary relief to broker dealers impacted by MiFID II, which was later extended.[32] The temporary relief permitted broker-dealers to receive separate payments for research—without being subjected to investment adviser registration. This relief period expired on July 3, 2023. As such, broker-dealers who receive separate compensation for providing research to customers (i.e., "hard dollars") must analyze whether the provision of such services implicates investment adviser registration obligations at either the SEC or state level, or whether exemptions might be relied upon.[33]

D. Any Publisher

Subsection 202(a)(11)(D) excepts the publisher of any bona fide newspaper or financial publication of general and regular circulation. In 1985, the Supreme Court concluded that this exception is available to any publisher satisfying three elements with respect to its publication(s):

- Impersonal advice — not tailored to the individual needs of a specific client or portfolio.
- "Bona fide" — disinterested commentary and analysis rather than promotional material disseminated by a "tout" or a "hit and run tipster."
- General and regular circulation — not timed to specific market activity or to events affecting the securities industry.[34]

E. Government Securities Advisers

Subsection 202(a)(11)(E) excepts any person whose advice, analyses and reports relate solely to U.S. Government securities or to securities issued by Government sponsored enterprises that the Treasury Secretary has designated as exempt securities under 1934 Act Section 3(a)(12).

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[31] *See* 15 U.S.C. § 80b-2(a)(11)(C).

[32] *See* Securities Industry and Financial Markets Association, SEC Staff No-Action Letter (Oct. 26, 2017) and Securities Industry and Financial Markets Association, SEC Staff No-Action Letter (Nov. 4, 2019) (extension of relief to Jul. 3, 2023).

[33] *See* Mayer Brown Legal Update, SEC Division Director: Staff MiFID II Research Compensation Relief to Expire July 2023 (Aug. 8, 2022).

[34] *See Lowe v. SEC*, 472 U.S. 181 (1985).

F. Statistical Rating Organizations

Subsection 202(a)(11)(F) excepts any nationally recognized statistical rating organization, as that term is defined in 1934 Act Section 3(a)(62), "unless such organization engages in issuing recommendations as to purchasing, selling, or holding securities or in managing assets, consisting in whole or in part of securities, on behalf of others." This exception was added to the Act in 2006 as a result of the collapse of such firms as *Enron* and *WorldCom*.[35]

G. Family Offices

Subsection 202(a)(11)(G), added to the Advisers Act by Dodd-Frank Section 409(a), excepts certain "family offices" as defined by the SEC.[36] The SEC adopted rules defining and regulating family offices for purposes of this exemption.[37] In addition, the SEC Staff has issued guidance on the new exemption in the form of Frequently Asked Questions ("FAQs").[38] In 2012, the Staff refused to grant no-action relief to a former employee of a registered investment adviser who sought permission to serve as a key employee to up to ten separate family offices (each representing a separate and distinct family) without registering as an investment adviser noting that "the exclusion for family offices does not extend to family offices serving multiple families."[39]

H. Other Persons

Subsection 202(a)(11)(H) gives the SEC authority to designate, by rule or by order, such other persons who are not within the intent of the investment adviser definition. Rule 202(a)(11)-1 discussed above was both adopted and vacated under this provision.[40]

IV. INVESTMENT ADVISERS EXEMPT FROM FEDERAL REGISTRATION

Advisers Act Section 203(a) provides that every investment adviser who uses the means of interstate commerce must register with the SEC unless exempted from registration by Section 203(b). In 1996, NSMIA added Section 203A to the Act which exempted advisers with less than $25 million in AUM from SEC registration if required to register under applicable state adviser laws. Dodd-Frank amended Section 203A to generally increase the AUM requirement to $100 million, but allowed advisers operating in 15 or more states to register with the SEC rather than each of the 15 separate states. Advisers relying on an exemption are not subject to federal registration, but are subject to Advisers Act Section 206, the antifraud provision.[41]

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[35] *See* Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, 120 Stat. 1327, 1337 (2006).

[36] *See* 124 Stat. at 1575, Section 409 ("Family Offices").

[37] *See* Family Offices, Release No. IA-3220 (Jun. 22, 2011) (final rule).

[38] *See* SEC Staff Responses to Questions About the Family Office Rule (Apr. 27, 2012).

[39] *See* Peter Adamson III, SEC No-Action Letter (Apr. 3, 2012).

[40] Rule 0-5 (17 CFR 275.0-5) describes the procedures for filing an application to obtain an order pursuant to this provision. This rule also applies to applications filed under Section 206A, which gives the SEC broad authority to exempt any person from any or all provisions of the Act. *See* Commission Policy and Guidelines for Filing of Applications for Exemption, Release No. IC-14492 (Apr. 30, 1985) (advising prospective applicants of procedures and guidelines to be followed when submitting exemptive applications).

[41] *See, e.g., Goldstein v. SEC*, 451 F.3d 873, 2006 U.S. App LEXIS 15760 at *7 (D.C. Cir. 2006) [hereinafter *Goldstein*]; Credit Agricole Asset Mgmt. Alternative Investments, Inc., SEC No-Action Letter, at n.7 (Aug. 7, 2006) [hereinafter *Credit Agricole*] (citing *Goldstein* for this proposition).

Under Dodd-Frank and subsequently adopted SEC exemptive rules, some exempt advisers are required to make regulatory filings despite their exempt status. The exemptions are discussed below.

A. Intrastate Adviser in Unlisted Securities

Section 203(b)(1), which previously exempted any "intra-state adviser," was amended by Dodd-Frank to exempt only intrastate advisers "other than an investment adviser who acts as an investment adviser to any private fund."[42] As amended, any investment adviser advising clients who are all residents of the state in which the adviser has its principal office and place of business, who does not advise any private funds and who does not furnish advice, analyses or reports regarding any security listed or admitted to unlisted trading privileges on any national securities exchange is exempt. However, state registration may still be required.

B. Advisers to Insurance Companies

Section 203(b)(2) exempts any adviser whose only clients are insurance companies. The SEC staff has acknowledged that U.S.-based advisers whose only clients are affiliated U.S. and non-U.S. insurance companies and do not hold themselves out to the public as advisers are not required to register.[43] The staff has also granted permission to a Canadian adviser to combine this exemption with the foreign private adviser exemption discussed below, allowing the adviser to circumvent the AUM and number of U.S. person client and investor limits set forth in the foreign private adviser exemption provided that its only U.S. clients are insurance companies.[44] In 2012, the staff concluded that a U.S. adviser whose only client is an unaffiliated foreign insurance company is exempt based on the meaning of "insurance company" as set forth in either Company Act Section 2(a)(17), which applies only to U.S. insurance companies, or Company Act Rule 3a-6, which includes foreign insurers, because Section 202(a)(12) defines "insurance company" as having the same meaning as in the Company Act, which the staff found ambiguous based on the difference between the statutory and regulatory definitions.[45]

C. Foreign Private Advisers

Dodd-Frank repealed former Section 203(b)(3), known as the "private adviser exemption,"[46] and added the "foreign private adviser" exemption.[47] At the same time, Dodd-Frank added to Advisers Act Section 202 a new definition of the term "foreign private adviser," which means any adviser who: (1) has no U.S. place of business; (2) has fewer than 15 clients and investors in the United States in private funds advised by the investment adviser; (3) has aggregate AUM attributable to clients in the U.S. and investors in the U.S. in

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[42] *See* 124 Stat. at 1571, which incorporates Title IV, "Regulation Of Advisers To Hedge Funds And Others," also known as the "Private Fund Investment Advisers Registration Act of 2010," at Section 403(1), "Elimination Of Private Adviser Exemption; Limited Exemption For Foreign Private Advisers; Limited Intrastate Exemption."

[43] *See* Zenkyoren Asset Mgmt. of Am. Inc., SEC No-Action Letter (Jun. 30, 2011); *see also* Allianz of Am., Inc., SEC No-Action Letter (May 25, 2012).

[44] *See* Industrial Alliance, Investment Mgmt. Inc., SEC No-Action Letter (Mar. 14, 2012).

[45] *See* TACT Asset Mgmt. Inc., SEC No-Action Letter (Oct. 24, 2012).

[46] Under the private adviser exemption, any adviser who, during the course of the preceding 12 months, had fewer than 15 clients and neither held itself out generally to the public as an investment adviser nor acted as an investment adviser to any investment company registered under the Company Act or to any "business development company" as defined under the Company Act was exempt from registration.

[47] *See* 124 Stat. at 1571, at Sections 403(2) and (3).

"private funds"[48] advised by the investment adviser of less than $25 million;[49] and (4) neither holds itself out generally to the public in the U.S. as an investment adviser; nor as an investment adviser to any U.S. registered investment company or to any "business development company" as defined under the Company Act.

The SEC subsequently adopted implementing regulations to flesh out the contours of the new exemption.[50] Under the rules, a foreign private adviser must have no place of business in the U.S. The SEC defines "place of business" broadly, including, for example, hotel rooms in the U.S. if used regularly to meet with clients.[51] The U.S. client or investor limit is fewer than 15 *in the aggregate*, and is not treated as two separate categories of U.S. clients. These U.S. person clients and investors must also represent less than $25 million in aggregate AUM. Foreign private advisers are required to count toward these aggregate limits proprietary assets and investors and clients from whom they receive no compensation.

With some exceptions, "U.S. person" status is generally determined by reference to Regulation S under the Securities Act of 1933 ("1933 Act") and is based on status at the time of becoming a client or at the time of acquiring securities in the private fund, as applicable. "Investors" include holders of short-term paper and persons with swap-based exposure.

The SEC and its Staff are expected to interpret "holding oneself out" as an adviser under the foreign private adviser exception in the same manner as it was previously interpreted under the private adviser exemption. Factors that indicate an adviser is holding itself out include:

- advertising advisory services;
- using "investment adviser" or a similar term on business cards or stationery;
- investment adviser listing in a telephone, business, or building directory;[52] and

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[48] See Dodd-Frank Section 402(a), 124 Stat. at 1570, which adds new Advisers Act Section 202(a)(29) that defines the term "private fund" to mean "an issuer that would be an investment company, as defined in section 3 of the . . . [Company Act], but for section 3(c)(1) or 3(c)(7) of that Act." *See* 124 Stat. at 1570. Use of offshore vehicles that *do not* rely on 3(c)(1) or (7) would prevent a look through to investors for counting U.S. persons (e.g., funds excluded from the Company Act under 3(c)(3), 3(c)(11) or Rule 3a-7).

[49] This AUM is subject to change since the statute gives the SEC authority to increase it to "such higher amount as the Commission may, by rule, deem appropriate in accordance with the purposes of this title." *See* Advisers Act Section 202(a)(30).

[50] *See* Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, Release No. IA-3222 (Jun. 22, 2011) [hereinafter, Exemptions Release].

[51] Both Rule 202(a)(30)-1 (the foreign private adviser exemption rule) and Rule 203(m)-1 (the private fund adviser exemption rule) under the Advisers Act refer to the "place of business" definition in Rule 222-1(a), which is defined to include: "(1) an office at which the investment adviser representative regularly provides investment advisory services, solicits, meets with, or otherwise communicates with clients; and (2) any other location that is held out to the general public as a location at which the investment adviser representative provides investment advisory services, solicits, meets with, or otherwise communicates with clients." Although interpretation of this definition is a facts and circumstances analysis and would include traditional office locations where firm personnel regularly meet with and provide advisory services to clients, the SEC has stated that "an office or other location where an adviser regularly conducts research *would be* a place of business because research is intrinsic to the provision of investment advisory services." Exemptions Release at 121. The SEC did note however that a place of business would not include "an office where an adviser solely performs administrative services and back-office activities if they are not activities intrinsic to providing investment advisory services and do not involve communicating with clients." *Id.*

[52] *See* Dale M. Mueller, SEC No-Action Letter (Feb. 20, 1984).

- letting it be known generally by word of mouth of one's availability to provide investment advice[53] or accept new clients.[54]

Although exempt from registration, foreign private advisers are subject to the antifraud provisions of the Advisers Act and to certain antifraud rules, including Rule 206(4)-6, the Pay-to-Play Rule, and Rule 206(4)-8, the Pooled Investment Vehicle Anti-Fraud Rule.

D. Private Fund Advisers

Dodd-Frank also added a very limited exemption for advisers to private funds.[55] The SEC included implementing regulations for this exemption with its foreign private adviser rulemaking. The rules applicable to private fund advisers differ based on whether or not the adviser has a principal office in the U.S. Advisers with no offices whatsoever in the U.S. may manage an unlimited number of U.S.-based private funds, U.S. fund investors and U.S. AUM in private funds, but may not have any **U.S. person clients other than private funds**.

If a foreign adviser has a satellite office in the U.S., personnel in that office may only manage private funds and those private funds must have aggregate AUM of less than $150 million. Advisers with a principal office in the U.S. may not have any clients, whether U.S. or non-U.S. persons, other than private funds and their total aggregate AUM must be below $150 million.

Like foreign private advisers, private fund advisers are subject to the antifraud provisions of the Advisers Act, the Pay-to-Play Rule and the Pooled Investment Vehicle Anti-Fraud Rule. However, private fund advisers are also considered "exempt reporting advisers" and are required to file a Form ADV Part 1 within 60 days of relying on the exemption from registration. Those who manage funds above a certain size are also subject to certain reporting requirements on Form PF.[56] They are also subject to SEC inspection, but at current resource levels, the SEC has indicated that inspection is unlikely other than in connection with an enforcement action.

E. Venture Capital Fund Advisers

Dodd-Frank also added an exemption for venture capital fund advisers.[57] Advisers whose only clients are certain types of private venture capital funds are exempt from registration. A qualifying private fund must: (1) represent to investors that it pursues a venture capital strategy; and (2) immediately after acquisition of any asset other than a "Qualifying Investment"[58] or short-term holdings (cash, cash equivalents, and U.S.

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[53] *See* Peter H. Jacobs, SEC No-Action Letter (Feb. 7, 1979).

[54] *See* Richard W. Blanz, SEC No-Action Letter (Jan. 28, 1985).

[55] *See* Dodd-Frank Section 408, adding Advisers Act Section 203(m), which is titled "Exemption Of And Reporting By Certain Private Fund Advisers." *See* 124 Stat. at 1575.

[56] *See* Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, Release No. IA-3308 (Oct. 26, 2011) [hereinafter Form PF Release] (this rulemaking was released jointly by the CFTC and the SEC). See Section V.E., below, for a brief synopsis of Form PF.

[57] *See* Dodd-Frank Section 407, adding Advisers Act Section 203(l), which is titled "Exemption Of And Reporting By Certain Venture Capital Fund Advisers." *See* 124 Stat. at 1574.

[58] A "Qualifying Investment" is essentially one in which the fund holds an equity security acquired *directly* from a "Qualifying Portfolio Company" ("QPC") or certain specified, related transactions. QPCs are limited to companies that: (1) at the time of investment by the fund, are not, and are not controlling, controlled by, or under common control with, a U.S. public reporting company or a

treasuries with remaining maturity of 60 days or less), the cost *or* fair value of all assets other than Qualifying Investments held by the fund must be no more than 20% of the fund's aggregate capital contributions plus uncalled capital commitments. According to the SEC staff, for purposes of meeting the Qualifying Investment requirement, a venture capital fund adviser may disregard an alternative investment vehicle ("AIV") used to hold an investment, if two requirements are met. First, the AIV must be formed solely to address investors' tax, legal or regulatory concerns and, second, the AIV must not be "intended to circumvent the VC Exemption's general limitation on investing in other investment vehicles."[59]

Although a venture capital fund can use cost *or* fair value, it must pick one and use it consistently. Such funds may not borrow, issue debt, provide guarantees, or otherwise employ leverage in excess of 15% of their aggregate capital contributions and uncalled capital commitments, and all such leverage (in any form) must be for a non-renewable term of less than 120 days. Generally, a venture capital fund may not issue any securities that have withdrawal, redemption, or repurchase provisions and cannot be registered under the Company Act. "Grandfathering" is available for certain funds that opened prior to December 31, 2010 and ceased taking capital commitments as of July 21, 2011.

Like private fund advisers, venture capital fund advisers are also considered "exempt reporting advisers" and are required to file a Form ADV Part 1 within 60 days of relying on the exemption from registration. However, venture capital fund advisers are exempt from filing Form PF.[60]

F. Charitable Organizations

Any investment adviser that is a charitable organization as defined in Company Act Section 3I(10)(B), or is a trustee, director, officer, employee, or volunteer of such a charitable organization, acting within the scope of such person's employment or duties with such organization, whose advice, analyses or reports are provided only to one or more of the following: (1) any such charitable organization; (2) a fund that is excluded from the definition of an investment company under Company Act Section 3(c)(10)(B); or (3) a trust or other donative instrument described in Company Act Section 3(c)(10)(B), or the trustees, administrators, settlors (or potential settlors), or beneficiaries of any such trust or other instrument.

G. Church Retirement Plans

Any plan described in Section 414(e) of the Internal Revenue Code of 1986 ("Code"), any person or entity eligible to establish and maintain such a plan under the Code, or any trustee, director, officer, or employee of or volunteer for any such plan or person, if such person or entity, acting in such capacity, provides investment advice exclusively to, or with respect to, any plan, person, or entity or any company, account, or

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company that has a security traded or listed on a foreign exchange or organized market; (2) do not borrow or issue debt in connection with the fund's investment in the company and distribute the proceeds of the borrowing or debt issuance in exchange for the fund's investment; and (3) are not an investment company, a 3(c)(1) or (7) fund, a commodity pool, or a vehicle relying on Company Act Rule 3a-7. In a 2013 Guidance Update, the SEC staff stated that it would not object to warehoused investments (which are, technically, non-"Qualifying Investments") being treated as "Qualifying Investments," so long as (1) the warehoused investment was acquired directly from a QPC for the purpose of acquiring that investment for the VC fund, and (2) the terms of the warehoused investment are fully disclosed to each investor prior to their committing to invest in the VC fund. *See* Guidance on the Exemption for Advisers to Venture Capital Funds, IM Guidance Update No. 2013-13 (Dec. 2013).

[59] Guidance on the Exemption for Advisers to Venture Capital Funds, IM Guidance Update No. 2013-13 (Dec. 2013).

[60] *See* Form PF Release, at 7 n.15 ("Advisers solely to venture capital funds or advisers solely to private funds that in the aggregate have less than $150 million in [AUM] . . . ('exempt reporting advisers') are not required to file Form PF"), and at Section II.A.7.

fund that is excluded from the definition of an investment company under Investment Company Act Section 3(c)(14) is exempt from registration.

H. Commodity Trading Advisors

Prior to Dodd-Frank, any investment adviser registered with the Commodity Futures Trading Commission ("CFTC") as a commodity trading advisor ("CTA") whose business did not consist primarily of acting as an investment adviser, as defined in Section 202(a)(11), and did not act as an investment adviser to a U.S.-registered investment company or a business development company, was exempt. Dodd-Frank amended this exemption to explicitly exempt any CTA to a "private fund" as long as the business of the CTA is not "predominately the provision of securities-related advice."[61] However, the CFTC has adopted rules and rule amendments requiring certain advisers, formerly exempt from registration as a CTA or as a commodity pool operator ("CPO"), to register with the National Futures Association ("NFA") as CTAs or CPOs under certain circumstances.[62] However, advisers that are registered with the SEC and whose business does not consist primarily of acting as a CTA, and that do not act as a CTA to any pool engaged primarily in the trading of commodity interests, are exempt from registration with the CFTC.[63]

I. Small Business Advisers

Dodd-Frank also added a new Section 203(b)(7) exempting from registration advisers who solely advise certain small business investment companies.[64] Among other things, to qualify for exemption, the adviser itself may not be "any entity that has elected to be regulated or is regulated as a business development company."

J. State Regulated Advisers

NSMIA divided the regulation of investment advisers between the SEC and the states, adding Section 203A to the Act. Dodd-Frank amended certain thresholds included in that section to place more advisers under state regulation.[65] The SEC now regulates only advisers that manage assets over $100 million, unless they: (a) advise registered investment companies; (b) advise certain business development companies; (c) would be required to register in 15 or more states; (d) have their principal office and place of business in a state that has no registration requirement, or a state that does not subject its registered advisers to examination (i.e., New York) or is located outside of the U.S.;[66] or (e) are otherwise exempted by the SEC from the general

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[61] *See* Dodd-Frank Section 403, amending Advisers Act Section 203(b)(6). 124 Stat. at 1571.

[62] *See* Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations, CFTC Release No. 3038-AD30 (Feb. 8, 2012). Advisers providing advice to private funds which include aggregate futures and/or swaps positions equal to 5% or more of the notional value of a portfolio may be required to register as a CPO. *See* amended CFTC Rule 4.13.

[63] *See* § 4m(3) of the Commodity Exchange Act of 1936, as amended, 7 U.S.C. § 6m(3).

[64] *See* Dodd-Frank Section 403, 124 Stat. at 1571, adding Advisers Act Section 203(b)(7).

[65] *See* Dodd-Frank Section 410, 124 Stat. at 1576, amending Advisers Act Section 203A, which is titled "State And Federal Responsibilities; Asset Threshold For Federal Registration Of Investment Advisers."

[66] Although foreign advisers are permitted (and sometimes required) to register with the SEC, the SEC has made clear that the substantive provisions of the Act do not apply to the foreign clients of a foreign SEC-registered adviser, although it has required that certain records are required to be maintained and subject to SEC inspection in order to protect U.S. clients and markets. *See* Exemptions Release at footnote 515 and related text; *see also* Uniao de Bancos de Brasileiros S.A., SEC No-Action Letter (Jul. 28, 1992); *cf.* Div. of Inv. Mgmt., SEC, Protecting Investors: A Half Century of Investment Company Regulation (1992) (more specifically, see Chapter 5, "The Reach of the Investment Advisers Act of 1940").

prohibition on SEC registration. Section 203A(a) prohibits investment advisers that do not fall into one of these categories from registering with the SEC under the Advisers Act.[67] The prohibition was designed to eliminate duplicative oversight of investment advisers and allow the SEC to focus its resources on larger advisers.

Rule 203A-2 exempts from the prohibition on registration certain other categories of advisers and was amended as part of rulemakings arising out of Dodd-Frank.[68] As amended, 203A-2 exempts: (a) pension consultants if the aggregate value of plan assets to which they provide investment advice is at least $200 million;[69] (b) certain affiliates of federally registered advisers; (c) start-up advisers that have a reasonable expectation they will be eligible to register with the SEC within 120 days of registration; (d) advisers required to be registered with 15 or more states; and (e) advisers who provide investment advice to clients exclusively through an interactive website or, during the preceding 12 months, provided investment advice to fewer than 15 clients through means other than an interactive website, but provided advice to all other clients exclusively through an interactive website.

Even though Section 203A provides that certain investment advisers are required to register only with the state where the adviser maintains its principal office and place of business, certain federal regulations apply to those investment advisers, such as federal antifraud and insider trading prohibitions, certain contractual requirements, and limitations on principal and agency cross transactions. Conversely, federally registered advisers may be subject to state-imposed antifraud standards. States may also require federally registered advisers to file a "notice" registration (sometimes including a filing fee), alerting the state that the adviser is doing business in the state and to register its "investment adviser representatives" with the state.[70] Finally, with respect to state registration requirements, NSMIA created a national de minimis standard under which no state may require an adviser to register unless the adviser: (a) has a place of business in that state; or (b) has had six or more clients in that state in the preceding 12-month period.[71]

V. INVESTMENT ADVISER REGISTRATION

All non-exempt investment advisers who are not prohibited from registering with the SEC must register by electronically filing Form ADV through the Investment Adviser Registration Depository ("IARD") operated by the Financial Industry Regulatory Authority, Inc. ("FINRA"). Once registered, an adviser is subject to expanded SEC jurisdiction over a wide range of its activities, including many activities which may not involve interstate commerce.[72] Exemption from registration, however, does not provide an exemption from all

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[67] *See*, *e.g.*, *Credit Agricole*, *supra* note 41.

[68] *See* Rules Implementing Amendments to the Investment Advisers Act of 1940, Release No. IA-3221 (Jun. 22, 2011) [hereinafter ADV Release].

[69] Pension consultants are exempt from the Regulatory Assets Under Management ("RAUM") calculation discussed in Section V.A., below with respect to securities of private funds. As long as the adviser provides advice to $200 million or more of "assets of plans," SEC registration is permissible for advisers who provide advice primarily on non-securities assets. *See* Rules Implementing Amendments to the Investment Advisers Act of 1940, Release No. IA-1633 (May 15, 1997). ("As used in rule 203A-2(b), the term 'assets of plans' is not limited to securities portfolios . . . .")

[70] Rule 203A-3 defines the term "investment adviser representative" ("IAR") for purposes of determining whether a state may require IAR registration. To be an IAR, one must have more than 5 clients who are natural persons (excluding "qualified clients," as defined below in Section IX.A.) and such clients constitute more than 10 percent of the IAR's total clients.

[71] Advisers Act Section 222(d).

[72] *See, e.g.*, Section 203(d) (prohibiting investment advisers from engaging in prohibited transactions regardless of whether the adviser uses the mails or any means of interstate commerce in connection with the action).

provisions of the Advisers Act. For example, the antifraud provisions of the Act and certain of its related rules apply to *all* investment advisers who make use of U.S. jurisdictional means, whether or not the advisers are registered or required to register.

Form ADV, the adviser registration statement, is primarily a disclosure document that gives information both to the SEC and the states for their administrative purposes and to advisory clients for disclosure purposes. The adviser's registration statement covers its employees and those it controls and the adviser's employees do not have to register themselves individually as investment advisers so long as their advisory activities are undertaken on behalf of the registered adviser.

In 2012, the SEC staff provided guidance permitting multiple related investment advisers to file a single, combined Form ADV if they were conducting a "single advisory business" (collectively, an umbrella registration).[73] Under this framework, the filing is made by the "filing adviser" and its related entities ("relying advisers") are named in the Form ADV, and information regarding the filing adviser and all relying advisers is incorporated into the single filing. In 2016, the SEC amended Form ADV to codify umbrella registration.[74] The changes became effective on October 1, 2017. In the 2016 adopting release, the SEC noted that the conditions for umbrella registration are "the same as the conditions set forth in the staff's [2012] guidance," excepting the staff's guidance concerning disclosure conditions for Form ADV. To file using umbrella registration, the following conditions must be satisfied:

- The filing adviser and each relying adviser advise only private funds and separate account clients that are "qualified clients" (as defined in Advisers Act Rule 205-3) and are otherwise eligible to invest in the private funds advised by the filing adviser or a relying adviser and whose accounts pursue investment objectives and strategies that are substantially similar or otherwise related to those private funds.

- The filing adviser has its principal office and place of business in the United States and, therefore, all of the substantive provisions of the Advisers Act and the rules thereunder apply to the filing adviser's and each relying adviser's dealings with each of its clients, regardless of whether any client or the filing adviser or relying adviser providing the advice is a United States person.

- Each relying adviser, its employees and the persons acting on its behalf are subject to the filing adviser's supervision and control and, therefore, each relying adviser, its employees and the persons acting on its behalf are "persons associated with" the filing adviser (as defined in Section 202(a)(17) of the Advisers Act).

- The advisory activities of each relying adviser are subject to the Advisers Act and the rules thereunder, and each relying adviser is subject to examination by the Commission.

- The filing adviser and each relying adviser operate under a single code of ethics adopted in accordance with Advisers Act Rule 204A-1 and a single set of written policies and procedures

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[73] American Bar Ass'n, Business Law Section, SEC No-Action Letter (Jan. 18, 2012).

[74] *See* Form ADV and Investment Advisers Act Rules, 81 Fed. Reg. 60418 (Aug. 25, 2016) [hereinafter "Form ADV and Advisers Act Amendments Adopting Release"].

adopted and implemented in accordance with Advisers Act Rule 206(4)-(7) and administered by a single chief compliance officer in accordance with that rule.[75]

- The filing adviser and each relying adviser must not be prohibited from registering with the SEC by section 203A of the Advisers Act (i.e., the filing adviser and each relying adviser must individually qualify for SEC registration).

A separate Schedule R must be completed for each relying adviser. It should be noted that Schedule R requires from each relying adviser identifying information, SEC registration status, organizational form and information about control persons.[76]

An application for registration as an investment adviser begins with filing a completed Form ADV with the SEC through IARD and paying FINRA an initial filing fee, which varies depending upon the amount of the adviser's AUM.[77] Absent a hardship exemption, all investment advisers required to register with the SEC must file Parts 1 and 2A electronically on the IARD.[78]

A. Part 1A of Form ADV (for all U.S. and state-registered advisers)

Form ADV Part 1A requires disclosure of:

- identifying information (name, address, website, etc.);

- whether the adviser is filing an umbrella registration and, if so, information concerning the relying advisers (including new Schedule R);

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[75] Analogous relief was also provided to exempt reporting advisers that are related persons through the FAQs related to Form ADV. The FAQ provided that affiliated exempt reporting advisers could satisfy their reporting obligations by filing a single Form ADV provided that: (i) the non-filing entities act only for private funds or other pooled investment vehicles advised by the filer; (ii) the filer controls the non-filing entities; (iii) the investment advisory activities of the non-filers are subject to the Advisers Act; (iv) the non-filers have no employees or other persons acting on its behalf other than officers, directors, partners or employees of the filer; and (v) the non-filers, their officers, directors, partners, employees and persons acting on their behalf are subject to the filer's supervision and control and, therefore, are "persons associated with" the filer (as that term is defined in Section 202(a)(17) of the Advisers Act). *See* SEC, *Frequently Asked Questions on Form ADV and IARD* (last visited Apr. 2, 2015).

[76] Form ADV and Advisers Act Amendments Adopting Release, *supra*.

[77] In addition to filing Form ADV and submitting the appropriate fees, a non-resident registering as an investment adviser must furnish an irrevocable consent and power of attorney designating the SEC as agent upon whom may be served any process, pleadings or other papers in any civil suit, where such suit: (1) relates to the business of the adviser; (2) is based on federal securities law; and (3) is brought in a court subject to U.S. jurisdiction. *See* Instruction 1 to Form ADV-NR and Advisers Act Rule 0-2.

[78] Rule 203-3 sets forth the following two types of hardship exemptions and the procedures involved in requesting these exemptions: (1) temporary exemptions for advisers who encounter unanticipated technical difficulties that prevent them from submitting a filing online; and (2) continuing hardship exemptions for small businesses.

Application for temporary exemption requires filing Form ADV-H (hardship exemption) no later than one business day after the filing that is the subject of the ADV-H was due. A temporary hardship is effective upon filing a completed Form ADV-H. After filing Form ADV-H, the adviser must submit the actual filing online with the IARD no later than seven business days after the original filing was due.

An adviser qualifying as a "small business" as defined in the Rule must file Form ADV-H at least 10 business days before a filing is due. Unlike the temporary exemption, which is effective upon filing, the continuous hardship exemption is not effective until and unless the SEC approves the application. Rule 203-3 requires the SEC to grant or deny the application for a continuous exemption within 10 business days after the adviser files Form ADV-H.

- total number of branch offices at which the adviser conducts its investment advisory business;
- the addresses for all websites and publicly available social media accounts where the adviser controls the content;
- if the adviser's CCO is compensated or employed by a third party, the name and EIN of the third party;
- whether the adviser is eligible for SEC registration and, if so, under what provision(s);
- form of organization;
- successions or change in legal structure or status;
- information about the adviser's business (e.g., employees, clients, regulatory assets under management ("RAUM"),[79] investment supervisory and other advisory services, participation in wrap fee programs and information regarding separately managed accounts);
- certain kinds of marketing materials and advertisements the adviser creates and uses;
- other business activities and financial industry affiliations;
- participation or interest in client transactions, discretion, and custody, if any;
- control persons;
- whether the adviser has been involved in certain disciplinary actions or events, with specific disclosure of actions required on Disclosure Reporting Pages ("DRPs");
- number and size of discretionary and non-discretionary accounts;
- a description through schedules of the ownership structure of the investment adviser (anyone who beneficially owns 5% or more of any class of the adviser's equity securities must be listed on an ownership schedule); and
- a description through schedules of private funds sponsored and/or managed by the adviser or its affiliates.[80]

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[79] RAUM, a newly defined ADV term, was added to the Part 1A disclosure requirements by the ADV Release, see note 68, above. Part 1A, Instruction 5.b. explains how to calculate RAUM. Unlike AUM, which is required to be reported in Part 2, RAUM primarily means securities portfolios for which the registrant provides "continuous and regular supervisory or management services as of the date of filing." Securities portfolios include any client portfolios other than private funds if at least 50% of the total value of the account consists of securities and all assets of any private fund. For purposes of this instruction, "private fund" is defined to mean "an issuer that would be an investment company as defined in section 3 of the . . . [Company Act] for section 3(c)(1) or 3(c)(7)." Commingled investment vehicles excluded from the Company Act under other provisions are not "private funds" and their assets may not be counted unless each such fund's portfolio consists of at least 50% securities.

[80] The ADV Release, *supra* note 68, materially amended private fund disclosure to require significantly more information regarding each private fund advised or sub-advised by a registrant. The SEC's 2016 amendments to Form ADV required advisers to provide additional information about their business, including information about their separately managed accounts, social media activity,

B. Part 1B of Form ADV (only for state-registered advisers)

Part 1B requires disclosure of information such as:

- the states in which the investment adviser is licensed/registered, and
- the adviser's bonding and custody arrangements and financial planning services, if any.

C. Part 2 of Form ADV

Form ADV Part 2A, also known as the "Brochure," reflects more than a decade's worth of SEC proposals and industry comments.[81] It consists of 18 questions to be answered in narrative format, including questions on the adviser's business, AUM, investment style, fees, brokerage practices, disciplinary history, financial condition, conflicts of interest and proxy voting policy. In addition, as a result of Dodd-Frank-related rule amendments, Rule 204-3 ("Brochure Rule"), was amended to require advisers not only to deliver Part 2A no later than the execution of any advisory agreement, but also to deliver to clients either Part 2A or a summary of material changes any time Part 2A is materially amended. See Section XI.A., below, for more information on the Brochure Rule.

In addition, advisers are required to deliver to certain current and prospective clients Part 2B (the Brochure Supplement) disclosing information about certain of the adviser's personnel, including their educational background, business experience and disciplinary history. However, Part 2B is not required to be filed on IARD.

Within 45 days of properly filing Form ADV, the SEC must either grant registration or institute proceedings to deny it.[82] It can do so where the applicant has been convicted of a felony involving the purchase or sale of securities, or involving theft, larceny, forgery, etc. If the Staff that processes Form ADV has questions or problems with a filing, it typically will phone or write the registrant. The Staff may return any Form ADV that is not fully and properly completed, in which event the 45-day period will begin once the form is re-filed. If the Staff chooses, it may ask the registrant to agree to delay the effectiveness of its ADV so that any problems can be resolved.

To keep this registration in good standing, an adviser must amend its ADV when its answers to questions change. Rule 204-1 sets forth guidelines as to when one must amend. Routine items require amendment within 90 days after the end of the adviser's fiscal year if responses become inaccurate for any reason. More significant items require *prompt* amendment if they become inaccurate in a material manner. Every item of Part 2A requires prompt amendment to correct material errors or omissions.

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branch offices, source of chief compliance officer compensation and participation in wrap fee programs. Form ADV and Advisers Act Amendments Adopting Release, *supra*.

[81] In 2000, the SEC proposed amendments to Form ADV Parts I and II. *See* Electronic Filing by Investment Advisers; Proposed Amendments to Form ADV, Release Nos. 34-42620, IA-1862 (Apr. 5, 2000) (proposed rule). However, the SEC only adopted amendments to Part I and related rules, deferring adoption of amendments to Part II. *See* Electronic Filing by Investment Advisers, Amendments to Form ADV, Release Nos. 34-43282, IA-1897 (Sep. 12, 2000). In 2008, the SEC re-proposed a new Part 2. *See Amendments to Form ADV*, Release No. IA-2711 (Mar. 3, 2008). This proposal was amended and adopted in July 2010. *See* Amendments to Form ADV, Release No. IA-3060 (Jul. 28, 2010).

[82] Section 203(c)(2).

D. Form CRS (Client Relationship Summary) – Part 3 of Form ADV

The SEC adopted Form CRS, Form ADV Part 3 in 2019[83] primarily to require registered investment advisers and registered broker-dealers to provide a brief relationship summary to retail investors. The relationship summary is intended to inform retail investors about the types of client and customer relationships and services the firm offers; the fees, costs, conflicts of interest, and required standard of conduct associated with those relationships and services; whether the firm and its financial professionals currently have reportable legal or disciplinary history; and how to obtain additional information about the firm. Retail investors will receive a relationship summary at the beginning of a relationship with a firm, communications of updated information following a material change to the relationship summary, and an updated relationship summary upon certain events.

Form CRS consists of six items; within many are "conversation starters" that are prescribed questions that retail investors should ask their investment advisers. As with many new requirements, once they become effective, the Division of Examinations (referred to as OCIE when Form CRS became effective) examined investment advisers for compliance with this new requirement. As a result, it issued a Risk Alert soon thereafter.[84]

E. Form PF

Dodd-Frank authorized the Financial Stability Oversight Council ("FSOC") to collect additional information from private fund managers from the SEC and CFTC.[85] As a result, the SEC and the CFTC jointly adopted Form PF, a data gathering form for private fund managers.[86] The data collected is intended to assist FSOC in identifying systemic risks to financial markets. Form PF can be filed through the Private Fund Reporting Depository, part of the same online system as the IARD. However, Form PF is nonpublic and the SEC has promised that it will be provided only to "those that have a regulatory need to know."[87]

Form PF includes: (1) an exemption for small private fund advisers (i.e., those with less than $150 million in private fund AUM);[88] (2) a threshold of $1.5 billion hedge fund assets under management to be a "large hedge fund adviser"; (3) a threshold of $2 billion private equity fund assets under management to be a "large private equity fund adviser"; and (4) a threshold of $1 billion of liquidity fund assets under management for a "large liquidity fund adviser." Large private equity fund advisers and other private fund advisers that do not meet the various "large" thresholds have 120 days after fiscal year end to file Form PF.

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[83] IA Release No. 5247 (Jun. 5, 2019).

[84] *See* Mayer Brown Legal Update, SEC's OCIE Risk Alert – Exam Focus on Compliance with Regulation Best Interest and Form CRS (Apr. 8, 2020).

[85] *See* Dodd-Frank Section 112(d)(1), 124 Stat. at 1396, which authorizes FSOC to collect information from member agencies to support its functions.

[86] *See* Form PF Release, *supra* note 56. Form PF was amended in July 2014, as part of the SEC's money market fund ("MMF") reform rulemaking. Effective April 14, 2016, a liquidity fund adviser managing at least $1 billion in combined MMF and liquidity fund assets is required to report very similar portfolio information on Form PF as MMFs are required to report on Form N-MFP. *See* Money Market Fund Reform; Amendments to Form PF, Release Nos. 33-9616, IC-31166, IA-3879 (Jul. 23, 2014).

[87] *See* Remarks of SEC Chairman Mary Schapiro at SEC Open Meeting (Oct. 26, 2011).

[88] In counting assets to determine AUM for the small adviser exemption and the large adviser thresholds, advisers are not required to aggregate separately managed accounts with private funds for reporting purposes unless the separate account is managed alongside the private fund. In addition, advisers are not required to aggregate assets with affiliates for reporting purposes if the affiliates operate separately.

Large hedge fund advisers are required to file Form PF 60 days after each quarter end, and large liquidity fund advisers are required to file Form PF 15 days after each quarter end. The SEC on its own and jointly with the CFTC have adopted a number of amendments to Form PF since its initial adoption, expanding the types of information that must be filed by all types of Form PF filers.

Notably, in May 2023, the SEC adopted new "current reporting" requirements for large hedge fund adviser filers and quarterly reporting requirements for private equity fund adviser filers, respectively requiring reports to be filed within 72 hours of certain triggering events or within 60 days of quarter end. The triggering events for large hedge fund adviser filers include certain extraordinary investment losses, significant margin and default events, terminations or material restrictions of prime broker relationships, operations events, and events associated with withdrawals and redemptions. For private equity fund advisers, triggering events include removal of the fund's general partner, certain fund termination events (such as an early termination of a fund's investment period), or the occurrence of an adviser-led secondary transaction.

Then in February 2024, the SEC adopted additional amendments to Form PF, which will enhance how large hedge fund advisers report investment exposures, borrowing and counterparty exposure, market factor effects, currency exposure, turnover, country and industry exposure, central clearing counterparty reporting, risk metrics, investment performance by strategy, portfolio liquidity, and financing and investor liquidity to provide better insight into the operations and strategies of these funds and their advisers and improve data quality and comparability.[89]

Further, the amendments will require additional basic information about advisers and the private funds they advise, including identifying information, assets under management, withdrawal and redemption rights, gross asset value and net asset value, inflows and outflows, base currency, borrowings and types of creditors, fair value hierarchy, beneficial ownership, and fund performance to provide greater insight into private funds' operations and strategies, to assist in identifying trends, including those that could create systemic risk, to improve data quality and comparability, and to reduce reporting errors. The amendments will also require more detailed information about the investment strategies, counterparty exposures, and trading and clearing mechanisms employed by hedge funds, while also removing duplicative questions, to provide greater insight into hedge funds' operations and strategies, to assist in identifying trends, and to improve data quality and comparability. The updated Form PF asks for information, including:

- information about the investment adviser's assets under management and, with respect to each reporting fund, withdrawal and redemption rights, gross asset value and net asset value, inflows and outflows, base currency, borrowings and types of creditors, fair value hierarchy, beneficial ownership, and performance;

- information about investment strategies, counterparty exposures, and trading and clearing mechanisms employed by each hedge fund advised by the Form PF Filer;

- separate reporting for each component fund of a master-feeder arrangement and parallel fund structure; and

[89] *See* Press Release, SEC, SEC Adopts Amendments to Enhance Private Fund Reporting (Feb. 8, 2024).

- reporting of "trading vehicles" used by reporting funds.[90]

The SEC extended the compliance date for the amendments to Form PF that were adopted on February 8, 2024. The compliance date for these amendments, which was originally March 12, 2025, has been extended to June 12, 2025.[91]

VI. INVESTMENT ADVISER'S FIDUCIARY DUTY

Fundamental to the Act is the concept that an adviser owes its clients a fiduciary obligation that is intended to eliminate conflicts of interest and to prevent the adviser from overreaching or taking unfair advantage of a client's trust. A fiduciary owes its clients more than honesty and good faith alone. A fiduciary must be sensitive to the conscious and unconscious possibility of rendering less than disinterested advice, and it may be faulted even where it did not intend to injure the client and even if the client does not suffer a monetary loss.

In *Capital Gains*, the Supreme Court defined an adviser's fiduciary duty in the following terms:

> The Investment Advisers Act of 1940 reflects a congressional recognition "of the delicate fiduciary nature of an investment advisory relationship," as well as a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested.[92]

The "delicate fiduciary nature of an investment advisory relationship" was reiterated *In the Matter of Alfred C. Rizzo*,[93] where the SEC stated that an adviser's duty to have a reasonable, independent basis for his investment advice, otherwise known as suitability, flowed from such a fiduciary relationship. Other fiduciary principles to keep in mind are the adviser's duty of (a) best execution and (b) utmost and exclusive loyalty to the client. These fiduciary principals have been applied by the SEC to cover conduct, within the context of the advisory relationship, not involving securities transactions.[94] An adviser naturally might ask, "What is the source of the fiduciary duty?" An adviser's fiduciary duty is *not*:

- specifically set forth in the Act, although Section 206 deals generally with fiduciary duty;
- delineated by SEC rules; or

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[90] *See* Amended Form PF Frequently Asked Questions, SEC Division of Investment Management (Feb. 3, 2025). 17 CFR Parts 275 and 279.

[91] *See* Press Release, SEC, Extension of Form PF Amendments Compliance Date (Jan. 29, 2025).

[92] 375 U.S. at 191-92 (footnote omitted). The Supreme Court adopted for advisers the position espoused by Justice Cardozo in his landmark court opinion in *Meinhard v. Salmon*, 249 N.Y. 458 (1928), defining the duties of a fiduciary as follows:

> Many forms of conduct permissible in the workaday world for those acting at arm's length, are forbidden by those bound by fiduciary ties. A fiduciary is held to something stricter than the morals of the market place. Not honesty alone but the punctilio of an honor the most sensitive, is then the standard of behavior.

Id. at 464.

[93] *See* Alfred C. Rizzo, Release No. IA-897 (Jan. 11, 1984).

[94] *See* Release 1092.

- a result of a contract between the adviser and the client (i.e., it is not something that can be negotiated away).

Rather, a fiduciary duty is imposed on an adviser by operation of law because of the nature of the relationship between the two parties.

For decades (approximately 60 years), the understanding of this duty was left to judicial decisions and indirect interpretations of the duty by the SEC in proposing and adopting antifraud rules, bringing enforcement actions and SEC staff interpretations. On June 5, 2019, the SEC issued its final interpretation regarding the standard of conduct for investment advisers (the "Fiduciary Interpretation").[95] The SEC's objective of the Fiduciary Interpretations was to reaffirm and clarify certain aspects of an adviser's fiduciary duty under Section 206 of the Advisers Act. In the SEC's view, the Fiduciary Interpretation does not create new obligations. Key points in the Fiduciary Interpretation are as follows.

1. The Fiduciary Interpretation took no action regarding imposing on registered advisers:

   - Licensing and continuing education requirements for advisory representatives,

   - Obligations to deliver advisory account statements to clients that include fees/costs of advisory services, or

   - Specific financial responsibilities (e.g., net capital requirements). (The SEC noted that it continues to evaluate comments received.)

2. The Fiduciary Interpretation did not alter the overall interpretation that an investment adviser's fiduciary duty comprises two components: the duty of care and the duty of loyalty.

The duty of care requires an investment adviser to provide investment advice in the best interest of its client, based on the client's objectives. Under its duty of loyalty, an investment adviser must eliminate or make full and fair disclosure of all conflicts of interest that might incline an investment adviser (consciously or unconsciously) to render advice which is not disinterested so that a client can provide informed consent to conflict. An investment adviser's fiduciary duty is broad and applies to the entire adviser-client relationship, including advice about investment strategy, sub-adviser engagement, account type (whether to open and which type) and account roll overs. This duty follows the contours of the relationship between the adviser and its client, and the adviser and its client may shape that relationship by agreement provided that there is full and fair disclosure and informed consent. Accordingly, an adviser's fiduciary duty must be evaluated in the context of the agreed-on scope of the relationship between the adviser and the client. In particular, the specific obligations that flow from the adviser's fiduciary duty depend on what functions the adviser has agreed to assume for the client.[96]

For greater details on the SEC's view on the application of fiduciary duty to limiting liability to clients by contract (i.e., hedge clauses), see **Section XI. B (Other Substantive Provisions: Hedge Clauses)**.

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[95] Investment Advisers Act Release No. 5249 (Jun. 5, 2019).

[96] For greater detail on the Fiduciary Interpretation, *see* Mayer Brown Legal Update, SEC Publishes Final Interpretation of Investment Adviser Standard of Conduct (Jun. 14, 2019).

VII. ANTIFRAUD PROVISION AND RULES

Advisers Act Section 206, the statute's general antifraud provision, makes it unlawful for any investment adviser using the mails or interstate commerce to defraud, deceive, or manipulate any client or prospective client. Section 206 applies to all advisers, whether registered or not, and provides that it shall be unlawful for *any* investment adviser:

- to employ any device, scheme, or artifice to defraud any client or prospective client;
- to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;
- acting as principal for his own account or as broker for another client, knowingly to sell any security to or purchase any security from a client, or to effect any security transaction on behalf of the account of a client, without previously disclosing the details of the transaction to the client and obtaining the client's consent thereto (except when a client deals with a customer of a broker-dealer and the broker-dealer is not also acting as investment adviser in relation to the transaction); or
- to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative.

A. Principal Transactions

Section 206(3) specifically addresses "principal transactions," that is, securities transactions conducted by an adviser with a client when the adviser has an interest in the securities being traded or is representing another party to the transaction who has such an interest. An adviser **cannot**, acting as principal, knowingly buy any security from a client, or sell any security to a client without disclosing to the client, in writing, the capacity in which it is acting and obtaining client consent to each such transaction before completion of the transaction.[97] In 2013, the SEC made clear that this disclosure and consent obligation also extends to the adviser's principals.[98]

The adviser also must disclose, in the exercise of his general duties as a fiduciary, all relevant information necessary for the client to make a reasoned decision as to whether or not to give this consent. At a minimum, the adviser should disclose to the client: (a) the capacity in which the adviser proposes to act; (b) the cost to the adviser of any security which he proposes to sell to the client, or the resale price of any security which he proposes to buy from the client; and (c) the best price at which the transaction could be effected by or for the client elsewhere if that price is more advantageous to the client than the actual purchase or sale price. Disclosure of the cost or price of the securities to the adviser must be made in clear terms (i.e., not by means of a percentage or formula). It is the view of the SEC that all such disclosure requirements must be

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[97] The SEC interprets the phrase "before the completion of the transaction" to mean *prior to the settlement of the transaction*. Interpretation of Section 206(3) of the Investment Advisers Act of 1940, Release No. IA-1732 (Jul. 17, 1998).

[98] In September 2013, the SEC brought an enforcement action against an investment adviser's principal—who was the adviser's founder, managing member, COO, and head of research—for violating Section 206(2), (3), due to an undisclosed personal conflict of interest in a $7.5 million transaction from which the principal pocketed over $2.7 million. *See* Shadron L. Stastney, Release Nos. IC-30689, IA-3671 (Sep. 18, 2013). The SEC concluded that, by failing to disclose the principal's personal financial interest to the adviser or the fund, the principal had deprived the fund of the opportunity to decide whether to proceed with the transaction on an informed basis.

satisfied *before* settlement of each separate transaction. A "blanket" disclosure and consent normally is not sufficient absent specific relief granted by the SEC.[99]

All of the foregoing disclosure rules apply equally to the case of an adviser or its affiliate serving as broker for the account of a third party in a securities transaction with an advisory client. In these brokerage transactions, the adviser must disclose the entire brokerage commission charged by it or its affiliate in dollars and cents.

Rule 206(3)-1 allows dual registrants to satisfy the requirements of Section 206(3) when acting in a principal capacity in transactions with certain clients if the dual registrant is acting as an "investment adviser" solely by means of: (a) publicly made statements (written or oral);[100] (b) written materials or oral statements which do not purport to meet the objectives or needs of specific individuals or accounts; (c) through the issuance of statistical information containing no expressions of opinion as to the investment merits of a particular security; or (d) any combination of the foregoing. Such materials must include a statement, however, to the effect that if the purchaser of the materials uses the services of the adviser in effecting a securities transaction which is the subject of the communication, the adviser may act as principal for its own account or as agent for another person.

In response to the court decision vacating Rule 202(a)(11)-1,[101] the SEC adopted interim final temporary Rule 206(3)-3T, which allowed advisers to engage in certain principal transactions pursuant to a blanket consent rather than compliance with the trade-by-trade consent requirements of Section 206(3).[102] The temporary rule has had several expiration dates, but was extended until December 31, 2016, at which point the SEC allowed it to expire.[103] In August 2016, the SEC staff explained that it had allowed Rule 206(3)-3T to expire, because few firms were relying on the rule.[104] The staff stated that firms relying on Rule 206(3)-3T could apply for exemptive relief, provided that they can provide a similar means of compliance with Section 206(3). Thus, it is expected that in order to receive favorable exemptive relief, in lieu of expired Rule 206(3)-3T, broker-dealers acting as advisers will still need to, among other things: (1) exercise no discretion other than temporary or limited discretion over a client's account; (2) not be the issuer or underwriter, directly or indirectly through affiliates, sold to the client other than an underwriter of investment grade debt; (3) obtain

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[99] *See* Stephens, Inc., Release No. IA-1666 (Sep. 16, 1997) (although the adviser obtained written blanket consents to principal trades, blanket consents do not satisfy the requirements of Section 206(3)); *see also* In re Closed Loop Partners, LLC (Sep. 20, 2024) (failure to disclose conflicted loan transactions); *see also* *In re J.P. Morgan Investment Management Inc.* (Oct. 31, 2024) (discussing prohibitions on joint trades and principal trades).

[100] Publicly distributed materials or publicly made statements are those made to 35 or more persons who pay for access to this information.

[101] *See Financial Planning Ass'n v. SEC, supra* note 25.

[102] *See* Temporary Rule Regarding Principal Trades with Certain Advisory Clients, Release No. IA-2653 (Sep. 24, 2007) (interim final temporary rule).

[103] *See* Temporary Rule Regarding Principal Trades with Certain Advisory Clients, Release No. IA-2965 (Dec. 30, 2009); *see* Temporary Rule Regarding Principal Trades with Certain Advisory Clients (Correction), Release No. IA-2965A (Dec. 31, 2009) (extending date to Dec. 31, 2010); *see also* Principal Trades with Certain Advisory Clients, Release No. IA-3128 (Dec. 28, 2010) (extending the date to Dec. 31, 2012); *see* Temporary Rule Regarding Principal Trades with Certain Advisory Clients, Release No. IA-3522 (Dec. 20, 2012) (extending date to Dec. 31, 2014); *see* Temporary Rule Regarding Principal Trades with Certain Advisory Clients, Release No. IA-3984 (Dec. 17, 2014) (extending date to Dec. 31, 2016).

[104] *See* Letter from David W. Grim, Director, Division of Investment Management, SEC, to Ira D. Hammerman, Executive Vice President and General Counsel, SIFMA (Aug. 19, 2016).

a written revocable consent to such transactions; (4) disclose all related conflicts of interest; and (5) send to the client no less frequently than annually written disclosure of all such transactions.

The Staff has issued no-action relief to the general partner of hedge funds and its controlling persons to the effect that Section 206(3) does not apply to transactions between a client account and an account of which the investment adviser and/or its controlling persons, in the aggregate, own 25% or less.[105] The Staff concluded that significant factors in determining the applicability of Section 206(3) include the relationship of the personnel to the investment adviser, as well as the extent of the ownership interest of the investment adviser and/or its personnel in the account. The Staff further noted, however, that "ownership interests of an investment adviser and/or its controlling persons of 25% or less of an account may present the opportunity for significant conflicts of interest . . . creating incentives to overreach and treat unfairly the clients with which the account engages in transactions" and reminded advisers of their federal fiduciary duty with respect to clients and their duty of full and fair disclosure of all material facts. As a result, the Staff concluded that an adviser may be required "to disclose information about transactions effected by the adviser involving any account in which the adviser and/or its controlling persons have an ownership interest, regardless of whether section 206(3) also applies."

Company Act Section 17(a) generally prohibits, among others, affiliated persons of a registered investment company (which includes the company's investment adviser and affiliates thereof) from effecting principal transactions with that investment company, regardless of whether disclosure and consent has occurred.

Similarly, but beyond the scope of this Outline, principal transactions, and cross trades, described below, are prohibited with an account that is subject to ERISA and an Individual Retirement Account ("IRA"). Both ERISA and Section 4975(c)(1) of the Internal Revenue Code essentially make principal and cross trades with these kinds of account prohibited transactions.

B. Cross Trades

Typically, an adviser will use a "cross trade" to transact between two or more of its accounts or managed funds, when doing so benefits its clients. One primary benefit to clients from a cross trade is that both clients will avoid incurring brokerage commissions. It is important to note that special rules apply when doing a cross involving a client that is an ERISA plan, a registered investment company, or an IRA. Cross trades pose substantial risks for investment advisers due to the adviser's inherent conflict of interest to seek best execution for the selling and the buying client.

A 2014 SEC enforcement action demonstrates the potential pitfalls for an adviser who fails to ensure that the benefits from the cross trades are effected fairly between clients. According to the SEC's order, the adviser had engaged in illegal cross trading activity when it crossed securities at the bid price.[106] According to the SEC, by crossing at the bid price, the adviser had conferred the full benefit of the trades to the buying clients at the expense of the selling clients savings.[107] Similarly, in separate enforcement actions settled in

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[105] *See* Gardner, Russo & Gardner, SEC No-Action Letter (Jun. 7, 2006).

[106] Western Asset Mgmt. Co., Release Nos. IC-30893, IA-3763 (Jan. 27, 2014). For recent activity on this and similar topics *see*, *In re* Macquarie Investment Management Business Trust (Sep. 19, 2024) (discussing "odd-lots").

[107] *Id*. Because this activity also involved a registered investment company, the SEC also found that the adviser violated Section 17(a)(1) and (2) of the Company Act, in addition to violating Sections 203(e), 206(2), 206(4) and 207 of the Advisers Act and Rules 206(4)-7 and 206(4)-8(a)(2) thereunder. The Department of Labor also separately settled a proceeding against the adviser arising out of these same transactions based on the fact that several of the affected clients were employee benefit plans subject to ERISA. *See also* *In re* Putnam Investment Management, LLC and Zachary Harrison, Release Nos. IC-33257, IA-5050 (Sep. 27, 2018) (involving

December 2015 and August 2018, the SEC charged an adviser with federal securities laws violations arising from, among other things, the adviser's failure to implement compliance systems and controls to identify impermissible cross trading, after the SEC found that the adviser's portfolio manager had engaged in improper cross trading by executing sales at the highest bid price, rather than obtaining and using an average or midpoint between the bid price and ask price.[108]

C. Agency Cross Transactions

"Agency cross transactions" are defined as transactions in which an adviser acts (directly or through an affiliate) as broker for both the client and a person on the other side of the transaction.[109] Such transactions generally are not permissible if the adviser, acting alone or with an affiliated broker-dealer, recommends the transaction to both the purchaser and seller of a security unless notice and consent, on a transaction-by-transaction basis, has occurred.[110] As a practical matter, this requirement makes it impossible for an adviser to conduct agency cross transactions. The SEC recognized, however, that agency cross transactions may be beneficial to clients. Rule 206(3)-2 provides a regulatory safe harbor under which an investment adviser or a registered broker-dealer controlling, controlled by, or under common control with the investment adviser shall be deemed in compliance with the consent requirement for such transactions:

- the advisory client executes a written consent authorizing the transactions after first receiving full written disclosure with respect to all receipt of commissions and potential conflicts of interest;
- the adviser or broker-dealer sends a written confirmation to the client, at or before the completion of the transaction, including:
    - a description of the transaction,
    - the date the transaction took place,
    - an offer to furnish the time of the transaction on request, and
    - the source and amount of any remuneration received by the adviser or broker-dealer in connection with the transaction, or (in certain cases),[111] a statement whether any other remuneration was received or will be received and an offer to furnish the source and amount;

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alleged improper cross trade of residential mortgage-backed securities ("RMBS") between the firm's advisory accounts and sponsored mutual funds).

[108] *In re* Morgan Stanley Inv. Mgmt. Inc., Release Nos. 33-9998, 34-76729, IA-4299, IC-31947 (Dec. 22, 2015) and *In re* Hamlin Capital Management, LLC, Release No. IA-4983 (Aug. 10, 2018). In the 2018 enforcement action, the SEC also alleged that the adviser persuaded certain broker-dealers to adjust their price quotations for seven municipal bonds held in client portfolios to levels substantially above where the bonds had most recently traded in the market and that the adviser did not document any rationale for these upward adjustments.

[109] Rule 206(3)-2(b). The SEC has also viewed an agency cross transaction to exist in the context of an adviser effectively receiving a transaction-based fee in connection with a cross trade between two private fund clients, because the adviser was viewed as acting as a "broker" in connection with the trade. *See In re* Ophrys, LLC, Release No. IA-5041 (Sep. 21, 2018).

[110] Section 206(3).

[111] In the case of a purchase, if neither the adviser nor broker-dealer were participating in a distribution; in the case of a sale, if neither were participating in a tender offer.

- the adviser or broker-dealer sends to the client at least annually and as part of any account statement or summary, a written disclosure of the total number of agency cross transactions since the date of the last such statement or summary (or since the written consent was received) and the total remuneration received or to be received with respect to such transactions during the period; and

- each written disclosure and confirmation to a client regarding such transactions states conspicuously that the client may at any time by written notice to the investment adviser or the broker-dealer revoke its consent to agency cross transactions.

In addition, paragraph (c) of the agency cross transaction rule admonishes advisers that the rule does not relieve them of their responsibility to act in the best interests of their clients, including fulfilling their duty with respect to best price and execution for any transaction.

D. Portfolio Management Issues

A number of portfolio management practices, while not specifically barred by the Advisers Act, may violate an adviser's antifraud and fiduciary duties. The following general principles apply to portfolio management practices engaged in by an investment adviser:

- Suitability — Purchases of securities for clients must be "suitable" to client needs and meet any and all requirements set out in the relevant advisory contract.

- "Scalping" — Advisers and associated persons of advisers should not acquire securities, recommend such securities to clients in anticipation of prices rising due to client purchases, and then sell their securities at a profit, or otherwise trade in securities for their own accounts contrary to the recommendations made to clients.

- "Churning" — Advisers must not engage in excess trading in accounts to generate commissions for certain broker-dealers or affiliates, or for personal gain.

- Brokerage Allocation — Advisers must generally allocate brokerage on the basis of "best execution" of clients' trade orders.[112] Price is just one criterion to consider when determining whether

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[112] On October 16, 2023, the Division of Examinations of the U.S. Securities and Exchange Commission (the "Division") announced its examination priorities for 2024. While the Division typically announces its examination priorities near the start of the calendar year, this is the first time that the Division has published its examination priorities this early, to align with the start of the fiscal year. The Division stated its hope that this will better inform investors and registrants of key risks, trends and examination topics on which the Division intends to focus in 2024.

As in prior years, the Division's examination priorities focus on areas that the Division believes pose emerging risks to the markets or to investors, in addition to existing core risk areas. The Division acknowledged the short interval of eight months since the publication of the fiscal year 2023 priorities and noted that several areas of focus from last year will remain as priorities for the Division in fiscal year 2024. Notably, in contrast to previous examination priorities, there was no specific focus area concerning Environmental, Social and Governance ("ESG") issues in the 2024 examination priorities, although the wording of this year's areas of focus is certainly broad enough to capture ESG-related regulatory concerns.

For fiscal year 2024, the Division identified the following focus areas for various market participants, including: (i) examinations of investment advisers under the Investment Advisers Act of 1940 ("Advisers Act"), including registered investment advisers to private funds and funds registered under the Investment Company Act of 1940; (ii) registered investment companies, including mutual funds and exchange-traded funds; (iii) broker-dealers, including compliance with Regulation Best Interest ("Reg BI") and the use

brokerage meets the "best execution" requirement. Other relevant factors include quality and reliability of service, promptness, trading expertise, financial strength, research services, and availability of share classes with lower expense ratios.[113]

- "Soft Dollars" — Section 28(e) provides a safe harbor to money managers who use the commission dollars of their advised accounts to obtain eligible investment "research and brokerage services," provided that such person determines in good faith that the amount of the commission is reasonable in relation to the value of the brokerage and research services provided.[114]

- Trade Allocation — Advisers must have procedures in place that are designed to ensure that the trades and investment opportunities are allocated in such a manner that all clients are treated fairly and equitably.

- Valuation — Every adviser must have written policies and procedures for fair valuation of securities the values of which are not actively traded on public markets or otherwise readily available.

With respect to trade allocation, it is often advantageous for an adviser to "bunch" orders for various discretionary accounts in an effort to lower execution costs. While there is no definition of what constitutes a fair and equitable allocation system, the Staff has provided no-action relief allowing an adviser to aggregate orders for client accounts, including accounts in which affiliates of the adviser had an interest, so long as appropriate disclosure was made to clients (both in Form ADV and in a separate disclosure to clients) and adequate safeguards were implemented to ensure equitable allocation.[115] The Staff indicated that safeguards should include pre-allocation statements setting forth which account orders were being

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of Form CRS, financial responsibility rules and trading practices; and (iv) other market participants, including self-regulatory organizations, clearing agencies, municipal advisors, and security-based swap dealers, among others.

For more details concerning the Division's 2024 Risk Alert, *see* Mayer Brown Legal Update, SEC Announces 2024 Exam Priorities (Oct. 23, 2023).

[113] *See* Manarin Inv. Counsel, Ltd., Release Nos. 33-9462, 34-70595, IC-30740, IA-3686 (Oct. 2, 2013) (finding that adviser failed to seek best execution for its clients when the adviser caused the funds to invest in "Class A" shares with 12b-1 fees that were borne by the client funds and shareholders, and the adviser disregarded the availability of "institutional" mutual fund share classes that did not include the 12b-1 fees).

[114] Section 28(e) of the 1934 Act. Subparagraph (3) of Section 28(e) defines the brokerage and research services that are protected, stating that a person provides brokerage and research services insofar as the person:

a) furnishes advice, either directly or through publications or writings, as to the value of securities, the advisability of investing in, purchasing, or selling securities, and the availability of securities or purchasers or sellers of securities;

b) furnishes analyses and reports concerning issuers, industries, securities, economic factors and trends, portfolio strategy, and the performance of accounts; or

c) effects securities transactions and performs functions incidental thereto (such as clearance, settlement, and custody) or required in connection therewith by rules of the SEC or a self-regulatory organization of which such person is a member or person associated with a member or in which such person is a participant.

The SEC has previously stated that "the controlling principle to be used to determine whether something is research is whether *it provides lawful and appropriate assistance to the money manager in the performance of his investment decision-making responsibilities*" (emphasis added). *See* Interpretive Release Concerning the Scope of Section 28(e) of the Securities Exchange Act of 1934 and Related Matters, Release No. 34-23170 (Apr. 28, 1986) and Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934, Release No. 34-54165 (Jul. 18, 2006).

[115] *See* SMC Capital, Inc., SEC No-Action Letter (Sep. 5, 1995).

aggregated, assurance that no client would be favored over another, and average pricing (with costs shared on a *pro rata* basis). However, the Staff does not mandate any specific allocation method, responding instead that any fair allocation, including *pro rata*, random or rotation methods, may be employed.[116]

Several SEC enforcement actions offer guidance on what constitutes an inequitable allocation. For example, an adviser cannot allocate favorable trades more frequently to its performance-based fee clients than to its asset-based fee clients[117] nor favor one group of clients over another when allocating "hot IPOs."[118] Similarly, advisers cannot "cherry pick" or allocate securities that perform well to personal or favored accounts while allocating underperforming securities to other client accounts.[119]

The SEC is taking an increasingly aggressive approach to valuation decisions and is focusing on both the valuation process used and the process as described or disclosed to clients.[120] The SEC is examining whether the values assigned reflect the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date and whether the process was accurately documented or disclosed.[121]

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[116] *See* Pretzel & Stouffer, SEC No-Action Letter (Dec. 1, 1995).

[117] *See* McKenzie Walker Investment Mgmt., Inc., Release No. IA-1571 (Jul. 16, 1996).

[118] *See* Account Mgmt. Corp., Release No. IA-1529 (Sep. 29, 1995) (adviser found to be allocating hot IPOs disproportionately to "gratis," or non-fee paying "friends of the firm," clients).

[119] *See, e.g.*, Howarth Financial Services, Release No. 34-81585 (Sep. 12, 2017) (finding that the investment adviser disproportionately allocated profitable trades from its omnibus trading account to the adviser's principal's personal account); *see also* J.S. Oliver Capital Mgmt., Release Nos. 33-9446, 34-70292, IC-30682, IA-3658 (Aug. 30, 2013) (finding that the investment adviser and its sole control person had improperly allocated trades to hedge funds that the control person and his family had invested in, while directing the less profitable trades to other clients; further, finding that adviser had acted wrongly by advertising the performance of the fund to which the favorable trades had been allocated); *see also* MiddleCove Capital, LLC, Release Nos. 34-68669, IC-30351, IA-3534 (Jan. 16, 2013) (adviser found to have unfairly allocated appreciated trades to personal, family and business accounts and depreciated trades to clients by purchasing securities in omnibus account and delaying allocation until performance was known).

[120] *See, e.g.*, *In re* Sciens Investment Management, LLC and Sciens Diversified Managers, LLC, Release No IA-6315 (May 24, 2023) (adviser failed to adopt and implement reasonably designed valuation policies and procedures where funds held illiquid, hard to value assets, and Sciens charged fees based on asset valuations); *In re* Covenant Financial Services, LLC, Release No. IA-4672 (Mar. 29, 2017) (adviser's valuation policy provided that in determining fair value, the adviser would maximize use of "Level 2" observable inputs over "Level 3" unobservable inputs. In practice, the adviser relied almost exclusively on a third-party pricing service that used Level 3 unobservable inputs to value the fund's municipal bond holdings, even though at various points in time, there were other observable and unobservable inputs that should have been considered); *In re* Pacific Investment Management Company, LLC, Release No. IA-4577 (Dec. 1, 2016) (adviser had failed to accurately value a number of mortgage-backed securities positions that were less than $1 million in size, because the adviser had relied on a third-party pricing vendor's prices, which were for round lot positions (defined by the pricing vendor as positions with a value of at least $1 million)); *In re* Calvert Investment Mgmt., Inc., Advisers Act Release No. 4554 (Oct. 18, 2016) (adviser's fair valuations of certain bonds were primarily based on the output of a third-party analytical tool and that, after learning that the tool was flawed, the adviser failed to account properly for certain characteristics of the bonds, which substantially inflated the bonds' value); *In re* Oppenheimer Asset Mgmt. Inc., Release No. IA-3566 (Mar. 11, 2013) (adviser was found to have misrepresented to clients that fair valued securities held in a private fund were valued by the underlying manager and audited by an independent third-party auditor when, in fact, the adviser allowed its own portfolio manager to value private securities in the fund in contravention of its written valuation policies and procedures and its disclosures to clients).

[121] *See* KCAP Financial, Inc., Release Nos. 34-68307, AAE-3425 (Nov. 28, 2012); SEC v. Yorkville Advisors, LLC, No. 12-7728 (J. Daniels, S.D.N.Y.); *see also* J. Kenneth Alderman, Release No. IC-30300 (Dec. 10, 2012) (SEC settlement order with eight fund directors).

E. Private Fund Enforcement

The SEC also has continued to direct enforcement efforts towards private fund advisers. Historically, the SEC has brought enforcement actions against private fund advisers that receive undisclosed, miscalculated, or misallocated fees and expenses and undisclosed loans,[122] and for failures to disclose adequately conflicts of interest.[123] The SEC also has brought enforcement actions against private fund advisers for: (i) "horizontal misallocation," in which the private fund adviser misallocates expenses disproportionately amongst investors (e.g., with respect to different parallel funds) without express disclosure of such arrangements in the partnership agreement or related offering materials,[124] and (ii) "vertical misallocation," which is where

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[122] *See, e.g.*, *In re Carl C. Icahn and In re Icahn Enterprises L.P.* (Aug. 19, 2024) (discussing failure to disclose pledges); *In re Hudson Advisors L.P. and Lone Star Global Acquisitions Ltd.*, Release No. IA-6120 (Sep. 12, 2022) (adviser failed to disclose practice for calculating and charging fees to 14 private equity funds and unauthorized charges of fees); *In re Global Infrastructure Management, LLC*, Release No. IA-5930 (Dec. 20, 2021) (adviser failed to offset certain portfolio company fees against management fees charged to clients, as required under the offering and governing documents); *In re Diastole Wealth Management*, Release No. IA-5855 (Sep. 10, 2021) (adviser failed to disclose to investors in a private fund that the adviser periodically made loans to a company owned by the son of the principal of the advisory firm and that the private fund's investment in the company could be used to repay the loans made by the adviser); *In re Monsoon Capital*, Release No. IA-5490 (Apr. 30, 2020) (action involved beaches and violations associated with unauthorized borrowing of private fund assets by principal of fund manager); *In re* WCAS Management Corporation, Release No. IA-4896 (Apr. 24, 2018) (inadequate disclosure and conflicts associated with undisclosed payments made by a group purchasing organization to the fund manager, which the fund manager caused portfolio companies to hire for procurement services); *In re* TPG Capital Advisors, LLC, Release No. IA-4830 (Dec. 21, 2017) (inadequate disclosure concerning practice of accelerating "monitoring fees" (i.e., annual fees for rendering certain consulting and advisory services to portfolio companies of private equity funds), noting that disclosure regarding acceleration practices had only provided after the fund had closed); *In re* SLRA Inc., Release No. IA-4641 (Feb. 7, 2017) (failed to disclose the accrual of "Service Fees" until after the funds had been withdrawn to cover such fees); *In re* Apollo Mgmt. V, L.P., Release No. IA-4493 (Aug. 23, 2016) (inadequate disclosure concerning practices of accelerating "monitoring fees"); *In re* WL Ross & Co. LLC, Release No. IA-4494 (Aug. 24, 2016) (private fund adviser acted wrongly by interpreting an ambiguous provision in limited partnership agreements with certain fund clients (the provision stated that its management fee was to be reduced by a portion of its earned transaction fees) in a manner that favored the adviser, which resulted in the adviser receiving $10.4 million in additional management fees); *In re* Blackstreet Capital Mgmt., LLC, Release No. IA-4411 (Jun. 1, 2016) (adviser charged portfolio companies owned by a fund client "operating partner oversight" fees, which were not expressly authorized in the fund's governing documents and the fees were disclosed to the fund's limited partners only after the adviser received them); *In re* Blackstone Mgmt. Partners L.L.C., Release No. IA-4219 (Oct. 7, 2015) (inadequate disclosure by the adviser concerning its practice of accelerating "monitoring fees," as well as a legal services arrangement covering the adviser and the funds, which gave the adviser a larger discount on legal fees than that received by the funds).

[123] *See, e.g.*, *In re Van Eck Associates Corporation* Release No. 35132 (Feb. 16, 2024) (adviser failed to disclose a social media influencer's planned involvement and the sliding scale fee structure to the ETF's board in connection with its approval of the fund launch and of the management fee); *In re Mass Ave Global Inc.* (May 29, 2024) and *In re Winston Mubai Feng* (May 29, 2024) (MassAve, an investment adviser that made Asia-focused investments and that held more than $1 billion in regulatory assets under management, made a series of materially false and misleading statements about its flagship opportunity fund's holdings and exposures. These false statements were the result of modifications Feng made to underlying portfolio data, which MassAve then included in investor communications, such as its monthly tear sheets, summary portfolio snapshots, and top 10 position lists. Feng was responsible for making all investment decisions and was deeply involved in investor communications and raising money for the Fund); *In re Perceptive Advisors LLC*, Release No. 34-95673 (Sep. 6, 2022) (adviser failed to disclose conflicts of interest); *In re* SLRA Inc., Release No. IA-4641 (Feb. 7, 2017) (failed to disclose that certain services were being provided by an affiliate); *In re* Centre Partners Mgmt., LLC, Release No. IA-4604 (Jan. 10, 2017) (adviser did not disclose that its principals owned an interest in and sat on the board of an IT services company, which the adviser engaged to perform due diligence services on portfolio company investments on behalf of and paid for by fund clients); *In re* Fenway Partners, LLC, Release No. IA-4253 (Apr. 25, 2017); *In re* JH Partners, LLC, Release No. IA-4276 (Nov. 23, 2015); *In re* VSS Fund Management LLC and Jeffrey T. Stevenson, Release No. IA-5001 (Sep. 7, 2018) (private equity fund adviser failed to provide material information to fund investors in connection with an offer by the owner of the adviser to purchase fund interests from investors, near the end of the fund's life). *See also* Andrew Ceresney, Director of Division of Enforcement, SEC, Securities Enforcement Forum West 2016 Keynote Address: Private Equity Enforcement (May 12, 2016).

[124] *See, e.g.*, *In re* Platinum Equity Advisors, LLC, Release No. IA-4772 (Sep. 21, 2017); *In re* Kohlberg Kravis Roberts & Co., Release No. IA-4131 (Jun. 29, 2015); *In re* Lightyear Capital LLC, Release No. IA-5096 (Dec. 26, 2018); *see also* Andrew Ceresney, Director of

the misallocation occurs between the private fund adviser and its managed funds.[125] The SEC has also brought an enforcement action where an adviser failed to fully comply with the terms of fund documents concerning cross trades between managed funds.[126] Recently, the SEC has brought actions against investment advisers acting as unregistered broker-dealers.[127] Additionally, the SEC has sanctioned private fund advisers for failing to file Form PF, failing to comply with the Advisers Act Custody Rule, fraud and inadequate policies and procedures relating to Insider Trading.[128]

F. Antifraud Rules under Subsection 206(4)

Subsection 206(4) gives the Commission authority, by rule or regulation, to define and prescribe those acts or business practices which are fraudulent, deceptive, or manipulative. The Commission has adopted several rules pursuant to Subsection 206(4), dealing with adviser advertising, custody of clients' assets, client solicitation, disclosure of financial and disciplinary information, proxy voting, and compliance. As part of its post-NSMIA rulemaking activities, the SEC limited several of the anti-fraud rules to advisers registered or required to be registered with the Commission, thereby excluding advisers registered only with states from its enforcement responsibility. Under NSMIA, states may enforce their own anti-fraud requirements.

1. Investment Adviser Marketing and Advertising: Rule 206(4)-1

Rule 206(4)-1 proscribes various marketing and advertising practices as fraudulent, deceptive, or manipulative within the meaning of Section 206(4) (the "Marketing Rule"). Rule 206(4)-1 was originally adopted in 1961 (previously commonly known as the "advertising rule") and was revised and expanded significantly by the SEC in late 2020 to replace and modernize the governing advertising provisions (including codifying certain prior SEC staff positions on advertising), incorporate provisions from the former cash solicitation rule (rescinded Rule 206(4)-3), as well as amend Form ADV and the books and records rule (Rule 204-2) with respect to marketing and advertising.[129]

The Marketing Rule includes a two-prong definition of what constitutes an "advertisement"; imposes seven basic general prohibitions applicable to any advertisement (the "Seven Principals"); addresses restrictions and requirements for certain types of advertisements (e.g., performance advertising, testimonials,

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Division of Enforcement, SEC, Securities Enforcement Forum West 2016 Keynote Address: Private Equity Enforcement (May 12, 2016) (discussing "horizontal misallocation").

[125] *See, e.g.*, *In re* Potomac Asset Management Company, Inc., Release No. IA-4766 (Sep. 11, 2017); *In re* Capital Dynamics, Inc., Release No. IA-4746 (Aug. 16, 2017); *In re* Lincolnshire Management, Inc., Release No. IA-3927 (Sep. 22, 2014); *In re* Cherokee Investment Partners, LLC, Release No. IA-4528 (Nov. 5, 2015).

[126] *See In re* Paramount Group Real Estate Advisor LLC, Release No. IA-4726 (Jul. 6, 2017).

[127] *In re* Palos Management Inc. and Robert Mendel (Oct. 15, 2024).

[128] Press Release, SEC, SEC Charges 13 Private Fund Advisers for Repeated Filing Failures (Jun. 1, 2018). *See, e.g., In re OEP Capital Advisors*, Release No. IA 6514 (Dec. 26, 2023) (adviser's insider trading policies and procedures were inadequate); *In re Ares Management*, Release No. IA 5510 (May 26, 2020) (adviser's insider trading policies and procedures were inadequate); Press Release, SEC, SEC Charges Two Advisory Firms for Custody Rule Violations, One for Form ADV Violations, and Six for Both (Sep. 9, 2022) (advisers failed to have audits performed on private funds or to deliver audited financials to investors in certain private funds in violation of the Advisers Act Custody Rule); *In re* Allianz Global Investors U.S. LLC *(AGI US)*, Release No. 34-94927 (May 17, 2022) (adviser alleged to have committed fraud and pled guilty to criminal charges concerning the manipulation of numerous financial reports and other information to investors to conceal the magnitude of risk and the funds' actual performance). For discussion on similar topics *see In re* Hudson Valley Wealth Management Inc. and Christopher Conover (May 14, 2024) (conflicts of interest disclosure failures).

[129] Investment Adviser Marketing, Advisers Act Release No. 5653 (Dec. 20, 2020) (Release).

endorsements, and third-party ratings); and provides clarity on how the rule will apply to evolving technology and communication platforms. In addition, while the Marketing Rule (like the former advertising rule and cash solicitation rule) only applies to investment advisers registered with the SEC, exempt reporting advisers and investment advisers exempt from registration should consider whether and to what extent to comply with the Marketing Rule and the guidance provided in the Marketing Rule's adopting release (or at least the spirit thereof), given that these reflect the most recent distillation of the SEC and the staff's view regarding potential violations of Section 206 or, as applicable, Rule 206(4)-8 (the pooled investment vehicle antifraud rule).[130]

a) Definition of an Advertisement under the Marketing Rule

There are two prongs to the definition of "advertisement" in the Marketing Rule (an "Advertisement"). The first prong includes any *direct or indirect* communication an investment adviser makes to more than *one person* (or to one or more persons if the communication includes "hypothetical performance" (as defined in the Marketing Rule)) that offers:

- The investment adviser's investment advisory services with regard to *securities* to *prospective* clients or investors in a "private fund" (as defined in the Rule)[131] advised by the investment adviser ("Private Fund Investors"), or
- *New or additional* investment advisory services with regard to *securities* to *current* clients or Private Fund Investors.

There are three exclusions to this prong of the definition:

- Extemporaneous, live, oral communications ("Live Communications");
- Information contained in a statutory or regulatory notice, filing, or other required communication, provided that such information is *reasonably designed*[132] to satisfy the requirements of such notice, filing, or other required communication ("Regulatory Information");[133] and
- A communication that includes hypothetical performance that is provided: (i) in response to an unsolicited request for such information from a *prospective or current* client or Private Fund Investor; or (ii) to a *prospective or current* Private Fund Investor in a one-on-one communication.

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[130] For more detailed coverage of the Marketing Rule, including coverage of amendments to Rule 204-2 Books and Records Rule and to Form ADV, *see* Mayer Brown Legal Update, What is the Fate of the New Marketing Rule for Investment Advisers? (Feb. 10, 2021).

[131] A "private fund" has the same meaning as in Section 2(a)(29) of the Advisers Act and means an issuer that would be an investment company under Section 3 of the Investment Company Act but for the exclusions from the definition of "investment company" under Section 3(c)(1) or 3(c)(7) of the Investment Company Act (i.e., 3(c)(1) and 3(c)(7) private funds).

[132] This standard is a change from the less flexible proposal, which referenced information *required* to be contained in the regulatory document.

[133] However, if an adviser includes in such a communication information that is not reasonably designed to satisfy its obligations under applicable law, and such additional information offers the adviser's investment advisory services with regard to securities, then that information will be considered an Advertisement.

The first prong of the definition of Advertisement in the rule may seem straight forward, but it is riddled with potential complications, as the adopting release's lengthy discussions regarding various topics related to the definition demonstrates. Here are some highlights:

- *One Person Elements* – The SEC made clear that the one-on-one element in the definition's first prong would be satisfied regardless of whether the adviser makes the communication to a natural person with an account or multiple natural persons representing a single entity or account. For example, if an adviser's prospective investor is an entity, the exclusion permits the adviser to provide communications to multiple natural persons employed by or owning the entity without those communications being subject to the Rule. For purposes of this exclusion, the SEC also interprets the term "person" to mean one or more investors that share the same household. For example, a communication to a married couple that shares the same household would qualify for the one-on-one exclusion. The SEC cautioned, however, that communications such as bulk emails or algorithm-based messages that are nominally directed at or "addressed to" only one person, but are in fact widely disseminated to numerous investors would be subject to the Rule. The Adopting Release includes additional discussion of the one person aspect of the definition.

- *All Offers Approach* – The definition encompasses all offers of an investment adviser's investment advisory services with regard to securities regardless of how they are disseminated (e.g., emails, text messages, instant messages, electronic presentations, videos, films, podcasts, digital audio or video files, blogs, billboards, social media, newspapers, magazines, the mail), with limited exception. That said, the definition specifically references investment advisory services with regard to securities, as opposed to other types of services that the adviser might offer.

- *New/Additional Services, Prospective vs. Current Clients/Investors* – Among other nuances, the definition draws distinctions between prospective and current clients/investors, and draws distinctions between new and existing advisory services. Advisers need to decide whether to craft their policies and internal controls with these distinctions in mind, or adopt more inclusive policies and controls for ease of administration, compliance, and testing. Advisers will have a similar decision point with respect to the exceptions in the definition. The Adopting Release includes a detailed discussion of these aspects of the Rule, including the treatment of brand content, general educational material and market commentary, and a discussion of the fact that the definition does not include communications to retain clients/investors, which is a departure from the proposal.

- *Related Persons* – The SEC stated that it would generally view any advertisement about an investment adviser that is *distributed and/or prepared* by a related person (as that term is defined in Form ADV's glossary) of the investment adviser as an indirect communication by the adviser, and thus subject to the Rule. Given the broad definition of the term "related person," adopting, implementing and testing effective controls in this regard will be challenging for some advisers.

- *Indirect Communications* – The Adopting Release includes a detailed discussion of indirect communications, and in the context of master-feeder, funds of funds, and model portfolio provider relationships.[134] The SEC believes that whether a particular communication is a communication made by the adviser is a facts and circumstances determination. But the SEC was clear that where the adviser has participated in the creation or dissemination of an advertisement, or where an

[134] The adopting release did not specifically address sub-advisory relationships in a similar manner.

adviser has authorized a communication, the communication would be a communication of the adviser. *Advisers should pay particular attention to this portion of the Adopting Release.*

- *Adoption and Entanglement* – The Adopting Release includes a detailed discussion of "adoption" and "entanglement." These situations contemplate an adviser distributing information generated by a third party[135] or a third party including information about an adviser's investment advisory services in the third party's materials. According to the SEC, whether the third-party information is attributable to the adviser will require an analysis of the facts and circumstances to determine (i) whether the adviser has explicitly or implicitly endorsed or approved the information after its publication (adoption) or (ii) the extent to which the adviser has involved itself in the preparation of the information (entanglement). *Advisers should pay particular attention to this portion of the Adopting Release.*[136]

- *Social Media* – The Adopting Release includes a detailed discussion of the SEC's views regarding social media, which is, in part, related to the release's adoption and entanglement discussion. This discussion addresses hyperlinks, third-party posts on the adviser's website or social media page,

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[135] *See* also Advisers Act Release No. 3988 (Dec. 22, 2014); Advisers Act Release No. 4496 (Aug. 25, 2016); Advisers Act Release No. 4497 (Aug. 25, 2016); Advisers Act Release No. 4498 (Aug. 25, 2016); Advisers Act Release No. 4499 (Aug. 25, 2016); Advisers Act Release No. 4500 (Aug. 25, 2016); Advisers Act Release No. 4501 (Aug. 25, 2016); Advisers Act Release No. 4502 (Aug. 25, 2016); Advisers Act Release No. 4503 (Aug. 25, 2016); Advisers Act Release No. 4504 (Aug. 25, 2016); Advisers Act Release No. 4505 (Aug. 25, 2016); Advisers Act Release No. 4506 (Aug. 25, 2016); Advisers Act Release No. 4507 (Aug. 25, 2016); and Advisers Act Release No. 4508 (Aug. 25, 2016).

[136] In a 2014 enforcement action, the SEC charged F-Squared, an investment adviser that also served as a sub-adviser for certain funds, with, among other things, violations of Rule 206(4)-1(a)(5) due to F-Squared's misleading advertisements concerning the performance track record of an investment strategy. More specifically, the advertisements had: (1) incorrectly stated that the performance results were not back-tested and were actual performance when, in fact, the data was derived through back-testing, and (2) inflated the back-tested performance results by improperly implementing the quantitative strategy. *See In re* F-Squared Investments, Inc., Release No. IA-3988 (Dec. 22, 2014). Following on the *F-Squared* enforcement action, the SEC settled an administrative proceeding, in November 2015, which was brought against a manager of managers that employed F-Squared as a sub-adviser for certain funds. The SEC faulted the manager of managers for publicly disseminating false statements from F-Squared concerning the performance of F-Squared's trading strategy, and for failing to maintain adequate compliance policies and procedures concerning the accuracy of sub-advisers' marketing materials. *In re* Virtus Investment Advisers, Inc., Release No. IA-4266 (Nov. 16, 2015). In February 2016, the SEC settled an enforcement action against Cantella & Co., an investment adviser that had used F-Squared's performance claims concerning its AlphaSector strategy without obtaining sufficient documentation to substantiate such claims. *In re* Cantella & Co., Release No. IA-4338 (Feb. 23, 2016). In August 2016, the SEC settled enforcement actions against thirteen advisers that distributed F-Squared's performance claims concerning the AlphaSector strategy in their own advertisements without independently verifying the information. *See In re* AssetMark, Inc., Release No. IA-4508 (Aug. 25, 2016); *In re* BB&T Securities, LLC, Release No. IA-4506 (Aug. 25, 2016); *In re* Banyan Partners, LLC, Release No. IA-4499 (Aug. 25, 2016); *In re* Congress Wealth Mgmt. LLC, Release No. IA-4507 (Aug. 25, 2016); *In re* Constellation Wealth Advisors LLC, Release No. IA-4505 (Aug. 25, 2016); *In re* Executive Monetary Mgmt., LLC, Release No. IA-4503 (Aug. 25, 2016); *In re* J.J.B. Hilliard, W.L. Lyons, LLC, Release No. IA-4502 (Aug. 25, 2016); *In re* Ladenburg Thalmann Asset Mgmt. Inc., Release No. IA-4501 (Aug. 25, 2016); *In re* Prospera Financial Services, Inc., Release No. IA-4498 (Aug. 25, 2016); *In re* Risk Paradigm Group, LLC, Release No. IA-4504 (Aug. 25, 2016); *In re* Schneider Downs Wealth Mgmt. Advisors, LP, Release No. IA-4497 (Aug. 25, 2016); *In re* Shamrock Asset Mgmt. LLC, Release No. IA-4496 (Aug. 25, 2016). The SEC has continued to bring charges against firms in connection with using F-Squared's performance presentation issues. *See, e.g.*, *In re* Ameriprise Financial Services, Inc., Release No. IA-4822 (Dec. 8, 2017); In re Institutional Investor Advisers, Inc., Release No. IA-4824 (Dec. 8, 2017); *In re* Horter Investment Management, LLC, Release No. IA-4823 (Dec. 8, 2017); SEC v. Navellier & Associates, Inc., Civil Action No. 17-CV-11633 (D. Mass, filed Aug. 31, 2017); SEC v. Navellier & Associates, Inc., Litigation Release No. 23925 (Aug. 31, 2017).

and associated persons' own personal social media accounts—a challenging subject for advisers from a control perspective.[137]

- *Live Communications Exclusion* – The SEC clearly stated the limitations of this exclusion, namely that Live Communications do not include prepared remarks or speeches, such as those delivered from scripts, or slides or other written materials that are distributed or presented to the audience. This exclusion also does not include "live" or instantaneous written communications such as text messages or chats. Further, although the exclusion will apply to a broadcast communication, such as a webcast, that is an extemporaneous, live, oral communication, it will not apply to previously recorded oral communications disseminated by the adviser or other recordings that the adviser has an opportunity to review and edit before dissemination.

The second prong of the definition includes any "endorsement" or "testimonial" (as defined in the rule) for which an investment adviser provides compensation (cash or non-cash), directly or indirectly. There is one exclusion to this prong, and that's for Regulatory Information. Testimonials and Endorsements are discussed in more detail below.

b) The Seven Principles

The Marketing Rule establishes seven principles-based prohibitions in connection with the use of Advertisements. Specifically, an Advertisement may not:

1. Include an untrue statement of a material fact, or omit a material fact necessary to make the statement made, in light of the circumstances under which it was made, not misleading;

2. 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;

3. 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;

4. Discuss any potential benefits without providing fair and balanced treatment of any associated material risks or limitations;

5. Include a reference to specific investment advice provided by the adviser that is not presented in a fair and balanced manner;

6. Include or exclude performance results, or present performance time periods, in a manner that is not fair and balanced; or

7. Otherwise be materially misleading.[138]

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[137] With respect to personal accounts of advisory personnel, advisers should also be mindful of laws adopted in various states to protect employees, which can limit an employer's ability to access social media accounts and records under certain circumstances. *See, e.g.,* California Code, LAB 980.

[138] The SEC has used a prior version of this catch-all to charge an adviser for making false statements regarding GIPS compliance and GIPS verification. The adviser had falsely claimed it was in compliance with GIPS in certain magazine advertisements and in an

Consistent with the SEC's interpretation of the investment adviser standard of conduct, advisers should evaluate their Advertisements based on all of the relevant facts and circumstances, including the nature of the audience, as well as the manner in and circumstances under which the Advertisement is distributed. Enforcement actions have now been brought against investment advisers involving violations of the Marketing Rule.[139] The Division of Examinations now looks at marketing materials during exams and has started what appears to be a consistent pattern of expecting investment advisers to substantiate statements contained in marketing materials, including the investment adviser's website.[140]

c) Testimonials and Endorsements

In a change from the prior advertising rule, the Marketing Rule permits advisers to include certain testimonials and endorsements in Advertisements provided that certain conditions are met. These conditions, which differ depending on whether certain exemptions or other factors apply, include similar disclosure requirements that were required under the former cash solicitation rule, Rule 206(4)-3, which was rescinded and incorporated into the testimonial and endorsement provisions of the Marketing Rule. As such, requirements with respect to solicitation and referral arrangements are now included as an Advertisement under the Marketing Rule's second prong, which (as further discussed below) has expanded regulatory reach to arrangements involving non-cash compensation as well as those involving Private Fund Investors (previously not covered under the former cash solicitation rule).

Both the terms "testimonial" and "endorsement" are broadly defined under the Marketing Rule and have been expanded from the prior solicitation rule. A testimonial includes any statement by a current client or Private Fund Investor:

- About the client's or Private Fund Investor's experience with the adviser or its supervised persons;
- That directly or indirectly solicits any current or prospective client or Private Fund Investor to be a client of the adviser, or a Private Fund Investor; or
- That refers any current or prospective client or Private Fund Investor to be a client of the adviser, or Private Fund Investor.

Similarly, an endorsement is any statement by a person other than a current client or Private Fund Investor (in the case of an endorsement) that:

- Indicates approval, support, or recommendation of the adviser or its supervised persons or describes that person's experience with the adviser or its supervised persons;

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investment newsletter the adviser had failed to provide the returns required by the GIPS Advertising Guidelines. Additionally, the adviser had falsely claimed, in a Morningstar report, that a third party had verified its GIPS compliance "to the present," when in fact the GIPS verification firm had resigned months earlier. The SEC was ultimately not persuaded by various arguments raised by the adviser, including that GIPS-compliant advertising materials were available on the adviser's website and in GIPS-compliant presentations to prospective clients. In re ZPR Inv. Mgmt., Inc., Release No. IA-4249 (Oct. 30, 2015).

[139] *See* Mayer Brown Legal Update, SEC Charges Five Registered Investment Advisers for Marketing Rule Violations (Apr. 17, 2024).

[140] On April 14, 2024, the SEC's Division of Examinations published a risk alert covering observations with respect to compliance with the Marketing Rule's provisions based on recent adviser examinations. SEC Division of Examinations Risk Alert: Initial Observations Regarding Advisers Act Marketing Rule Compliance.

- Directly or indirectly solicits any current or prospective client or Private Fund Investor to be a client of the adviser, or a Private Fund Investor; or

- Refers any current or prospective client or Private Fund Investor to be a client of the adviser, or Private Fund Investor.

Under the Marketing Rule, Advertisements may not contain a testimonial or endorsement, and an adviser may not provide compensation, directly or indirectly, for a testimonial or endorsement, unless the adviser complies with the following conditions (or a relevant exemption applies). Unlike the prior cash solicitation rule, compensation under this provision of the Marketing Rule includes testimonials and endorsements involving both cash and non-cash compensation (such as gifts and entertainment or non-transferable advisory fee waivers in connection with refer-a-friend arrangements).

1. Disclosure Requirements. The adviser must disclose, or reasonably believe that the person giving the testimonial or endorsement (the "Promoter") discloses, the following at the time the testimonial or endorsement is disseminated:

   – Clear and Prominent Disclosure: The following must be clearly and prominently disclosed:

   - That the testimonial was given by a current client or Private Fund Investor, and the endorsement was given by a person other than a current client or Private Fund Investor, as applicable;

   - That cash or non-cash compensation was provided for the testimonial or endorsement, if applicable; and

   - A brief statement of any material conflicts of interest on the part of the Promoter resulting from the adviser's relationship with such person.

   – Other Disclosure: Although not subject to the "clear and prominent" requirement above, the following other disclosure must also be provided at the time a testimonial or endorsement is disseminated:

   - The material terms of the compensation arrangement, including a description of the compensation provided or to be provided, directly or indirectly, to the Promoter; and

   - A description of any conflicts of interest on the part of the Promoter resulting from the Promoter's relationship with the adviser and/or any compensation arrangement.

   The Marketing Rule adopting release noted that these disclosures can be provided either orally or in written form. However, because these disclosures are provided with respect to Advertisements, advisers must keep a record of any oral disclosures, either through an audio recording or a contemporaneous written record indicating that the required

disclosures were provided, the substance of what was provided and when the disclosures were made.[141]

2. Adviser Oversight and Compliance Requirements. The adviser must have both (i) a reasonable basis for believing that the testimonial or endorsement complies with the above requirements, and (ii) a written agreement with any Promoter that describes the scope of the agreed-upon activities and the terms of compensation for those activities. This is similar to requirements under the former cash solicitation rule, which have been incorporated into the Marketing Rule. The Release noted that a reasonable basis with respect to oversight could be established through requirements or conditions in the written agreement itself to help form a reasonable belief, periodic surveillance of prospects and periodic monitoring and oversight of Promoters by the adviser.

3. Disqualification Provisions. Lastly, an adviser may not compensate a Promoter, directly or indirectly, for a testimonial or endorsement if the adviser knows, or in the exercise of reasonable care should know, that the Promoter is an ineligible person at the time the testimonial or endorsement is disseminated. Ineligible persons include persons subject to a disqualifying SEC action barring, suspending, or prohibiting a person from acting in any capacity under the federal securities laws or a disqualifying event within the last 10 years.[142] In addition and similar to relief historically granted under the 2003 Dougherty & Co. no-action letters, the Marketing Rule provides a conditional carve-out from the definition of disqualifying event that permits an Adviser to compensate a Promoter that is subject to certain disqualifying actions, when the SEC has issued an opinion or order with respect to the promoter's disqualifying action, but not barred or suspended the Promoter or prohibited the Promoter from acting in any capacity under the federal securities laws, subject to conditions.[143]

4. Exceptions. The following types of testimonials and endorsements are exempted from certain of the above conditional requirements under the Marketing Rule.

   – No Compensation or De Minimis Compensation: A testimonial or endorsement disseminated for no compensation or de minimis compensation is not required to comply with the written agreement portion of the Adviser Oversight and Compliance

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[141] Despite this flexibility, advisers might consider retaining these required disclosures in written form for solicitation and referral arrangements in an effort to establish a reasonable belief that they have been provided consistently and in the manner required. In addition, and unlike the former cash solicitation rule, these disclosures are not required to be in a separate disclosure document that has to be signed and acknowledged by the recipient and a copy of the adviser's Form ADV Brochure is not required to be provided at the time the testimonial or endorsement is disseminated. However, the Marketing Rule adopting release noted if the adviser or Promoter provides the "clear and prominent" disclosure items in writing, they should not be hidden away or buried in other disclosure documents (such as in the Form ADV Brochure) and must be as prominent as, and preferably within, the testimonial or endorsement itself.

[142] While similar to the disqualification provisions under the former cash solicitation rule, a disqualifying event under the Marketing Rule is slightly broader and includes the entry of a final order of the CFTC or a self-regulatory organization. However, the broader disqualification provisions under the Marketing Rule will not be applied retroactively to prior conduct (such as a CFTC order issued prior to May 4, 2021) when such conduct had not disqualified a solicitor under the former cash solicitation rule. In other words, the Marketing Rule will not disqualify a person for prior conduct that did not cause disqualification at that time under the former cash solicitation rule.

[143] *See* Dougherty & Co., SEC No-Action Letter (Jul. 3, 2003).

Requirements or the Disqualification Provisions. De minimis compensation means compensation paid to a person for providing a testimonial or endorsement of a total of $1,000 or less (or the equivalent value in non-cash compensation) during the preceding 12 months.

- Affiliates/Affiliated Personnel: A testimonial or endorsement by the adviser's partners, officers, directors, or employees, or a person that controls, is controlled by, or is under common control with the adviser, or is a partner, officer, director, or employee of such a person is not required to comply with the Disclosure Requirements and the written agreement portion of the Adviser Oversight and Compliance Requirements. However, the affiliation between the adviser and such person must be readily apparent or disclosed to the client or Private Fund Investor at the time the testimonial or endorsement is disseminated and the adviser must document such person's status at the time the testimonial or endorsement is disseminated.

- Registered Broker-Dealers: A testimonial or endorsement by an SEC-registered broker or dealer is not required to comply with:

    i. The Disclosure Requirements if the testimonial or endorsement is a recommendation subject to Regulation Best Interest;

    ii. The Other Disclosures portion of the Disclosure Requirements if the testimonial or endorsement is provided to a person that is not a retail customer as that term is defined in Regulation Best Interest (e.g., institutional clients rather than natural person clients); and

    iii. The Disqualification Provisions if the broker or dealer is not subject to a statutory disqualification, as defined under the Securities Exchange Act of 1934.

- Covered Persons under Regulation D: A testimonial or endorsement by a person that is covered by Rule 506(d) of the Securities Act of 1933 with respect to a Rule 506 securities offering and whose involvement would not disqualify the offering under that rule is not required to comply with the Disqualification Provisions.

d) Performance Presentation Requirements

Performance advertising continues to receive special scrutiny from the SEC due to its potential to mislead investors. With respect to any Advertisement that includes performance data, the Advertisement should not include the following (see greater details of some of these prohibitions, below):

- Gross performance, unless the Advertisement also presents net performance (with at least equal prominence, calculated over the same time and using the same type of return methodology as the gross performance);

- Any performance results, unless they are provided for specific time periods in most circumstances;

- Any statement that the SEC has approved or reviewed any calculation or presentation of performance results;

- Performance results from fewer than all portfolios with substantially similar investment policies, objectives, and strategies as those being offered in the Advertisement, with limited exceptions;

- 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;

- Hypothetical performance (which does not include performance generated by interactive analysis tools which meet certain criteria), unless the adviser adopts and implements policies and procedures reasonably designed to ensure that the performance is relevant to the likely financial situation and investment objectives of the intended audience and the adviser provides certain information underlying the hypothetical performance; and

- Predecessor performance, unless there is appropriate similarity with regard to the personnel and accounts at the predecessor adviser and the personnel and accounts at the advertising adviser.

In addition, the advertising adviser must include all relevant disclosures clearly and prominently in the Advertisement. The SEC notes that these rules will be applied on a facts and circumstances basis. Advisers should pay special attention to the particular context of each disclosure. If information in an Advertisement may result in an unwarranted assumption about the performance results, the Advertisement may be misleading.

e) Select Performance Marketing Practices

The SEC commented on specific performance marketing activities described above that frequently are used in the industry and that can raise questions concerning fair and balanced versus misleading presentations. The coverage of the following selected activities is voluminous in the Marketing Rule adopting release, and the devil is always in the details, which are plentiful. These practices are ultimately addressed in the final Marketing Rule based on principles and many of the previous prescriptions, from the previous rule itself or by no-action letters, no longer apply. Our coverage of the following performance marketing practices is intended to be high-level and should be considered only after the details, and their applicability, have been fully evaluated:

- Use of past specific recommendations

Under the prior advertising rule, an adviser wanting to include in an advertisement past specific recommendations that are or would be profitable had to also provide, or offer to provide, a list of all recommendations made during the prior 12 months, disclosure. Through the no-action letter process, the SEC staff got comfortable that specific past recommendations could be included provided such presentations were essentially fair and balanced. Industry standard practices developed over time in which an adviser that included favorable and profitable recommendations would also include unfavorable and unprofitable past positions, shown with equal prominence, and with disclosure. Otherwise, so long as specific recommendations were not selected based solely on performance, specific recommendations could be included in advertisements, again, with disclosure.

The SEC has essentially endorsed, and the Marketing Rule recognizes, this industry practice provided the information presented is fair and balanced. The SEC also clarified that the Marketing Rule applies in this respect without regard to whether a recommendation is current or occurred in the past. The SEC stated its belief that selective references to current investment recommendations could mislead investors in the same manner as selective references to past recommendations.

- Gross versus net performance

The Marketing Rule prohibits inclusion of gross performance in advertisements unless it also includes net performance with equal prominence, calculated over the same time period, and using the same type of return and methodology as gross performance. This net return requirement applies to all advertisements, whether directed at sophisticated institutional clients, prospects, Private Fund Investors, consultants, or in any retail setting. The Marketing Rule does not define how gross performance is to be calculated or what fees and expenses have to reduce gross performance to arrive upon net performance but, instead, provides a non-exhaustive list of the types of fees and expenses to be considered in preparing gross and net performance (although custodian fees need not be included in calculating net performance since, generally, clients negotiate their own arrangements and fees with custodians). Accordingly, the Marketing Rule is not prescriptive in this respect but more principles-based.

In January 2023, the staff of the SEC's Investment Management Division ("IM Staff") clarified in a FAQ that if an adviser displays the gross performance of one investment or a group of investments in a portfolio or private fund in an Advertisement, it must also show the net performance of that single investment or group of investments, respectively. However, two years later, in March 2025, the IM Staff reversed course, providing an amended FAQ permitting the use of gross-performance-only extracts, subject to a number of conditions, including that it be accompanied by a presentation of the total portfolio's gross and net performance presented with at least equal prominence and in a manner designed to facilitate comparison with, the gross-only extracted performance.[144]

On February 4, 2024, the IM Staff released another FAQ on the presentation of gross and net IRRs with respect to the use of credit facilities. It noted that it was aware that certain advisers to private funds are presenting a gross internal rate of return ("Gross IRR") in advertisements that is calculated from the time an investment is made (without reflecting fund borrowing or subscription/credit facilities) and then showing a net internal rate of return ("Net IRR") that is calculated from the time investor capital has been called to repay such borrowing. The IM Staff stated that when advertising a private fund's Gross IRR and Net IRR, presenting Gross IRR that is calculated *without* the impact of fund-level subscription facilities (i.e., fund-level Gross IRR) compared only to Net IRR that is calculated *with* the impact of fund-level subscription facilities (i.e., investor-level IRR) would violate the Marketing Rule.

As such, if an Advertisement included the Gross IRR of a private fund calculated from before capital commitments are called, then it would need also to show the Net IRR calculated from the same time before capital commitments are called (i.e., including the effect of fund-level subscription facilities in its calculation). In addition, if an Advertisement showed only Net IRR that includes the impact of fund-level subscription facilities, it must also include either (i) comparable performance (e.g., Net IRR without the impact of fund-level subscription facilities) or (ii) appropriate disclosures describing the impact of such subscription facilities on the net performance shown.[145]

In 2025, the IM Staff added an FAQ regarding the status of certain portfolio or investment metrics and characteristics (e.g., yield, coupon rate, contribution to return, volatility, sector or geographic returns, attribution analyses, the Sharpe ratio, the Sortino ratio, and other similar metrics) as "performance" under the Marketing Rule. If such metrics and characteristics are performance, then the Marketing Rule would

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[144] SEC Division of Investment Management, Marketing Compliance Frequently Asked Questions (Mar. 19, 2025).

[145] *Id*.

require that those metrics need to be presented on a net basis. In this FAQ, the SEC staff recognized the uncertainty regarding the status of these metrics as performance and further recognized that even if these characteristics were to qualify as performance, calculating these characteristics on a net basis may be impossible or lead to misleading or confusing results. In response to these challenges, the SEC Staff permitted gross-only portfolio/investment characteristics, subject to the following conditions (which echo those in the above guidance):

- The portfolio/investment characteristic must be clearly identified as being gross (i.e., calculated without the deduction of fees and expenses);

- The characteristic must be accompanied by total portfolio gross/net performance (presumably actual) that is calculated/presented in compliance with the Marketing Rule;

- Total portfolio return information must be at least as prominent as the characteristics, and in a manner designed to facilitate comparison with, the gross characteristic; and

- Total portfolio performance must be for a period at least as long as the period covered by the characteristic. However, the characteristics can be calculated over a single, clearly disclosed period, even when the accompanying gross and net performance of the total portfolio must be presented over one-, five-, and ten-year periods.[146]

The SEC staff also indicated that whether a presentation of a characteristic in an advertisement is subject to Rule 206(4)-1(d) in the first instance depends on whether such characteristic constitutes "performance." The SEC staff in this FAQ specifically declined to take a position on whether any particular characteristic or attribute should be considered "performance" for purposes of Rule 206(4)-1. To the extent a characteristic is not performance, the presentation of such characteristic would not be within the scope of Rule 206(4)-1(d). It is important to understand that this FAQ does not cover measures of total portfolio performance, such as total return, time-weighted return, return on investment, internal rate of return, multiple on invested capital, or Total Value to Paid in Capital, regardless of how such metrics are labeled in the advertisement.

In caution, the SEC Staff noted that any advertisement that presents characteristics in accordance with this FAQ remains subject to the general prohibitions of Rule 206(4)-1(a) (as well as sections 206(1) and 206(2) of the Advisers Act).[147]

- Presentation of Related Portfolios

The Marketing Rule contains specific requirements with respect to including comparisons of similarly managed portfolios in Advertisements, which is referred to as the presentation of "Related Performance." Specifically, "Related Performance" is defined as the performance results of one or more "Related Portfolios," either on a portfolio-by-portfolio basis or as a composite aggregation of all portfolios falling

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[146] *See* Mayer Brown Legal Update, Past Guidance is No Assurance of Future Guidance: SEC Staff Reverses Course with New Marketing Rule FAQs on Extracted Performance and Portfolio Characteristics (Mar. 21, 2025).

[147] SEC Division of Investment Management, Marketing Compliance Frequently Asked Questions (Mar. 19, 2025); *see also*, Mayer Brown Legal Update, Past Guidance No Assurance of Future Guidance: SEC Staff Reverses Course with New Marketing Rule FAQs on Extracted Performance (Mar. 21, 2025). Investment advisers should be aware that they can be subject to liability under Section 206 of the Advisers Act for the actions of third-party service providers. For additional discussion of this topic, *see* Mayer Brown counsel Leslie Cruz's articles SEC Regulatory Liability of Third-Party Fund Service Providers: A Hard Look Back and a Cautious Glimpse Forward—Part *1* (May 2024) and SEC Regulatory Liability of Third-Party Fund Service Providers: A Hard Look Back and a Cautious Glimpse Forward—Part 2 (Jun. 2024).

within stated criteria. A "Related Portfolio" is defined as a portfolio with substantially similar investment policies, objectives, and strategies as those of the services being offered in the Advertisement.

An Advertisement may not include any Related Performance, unless it includes all Related Portfolios; provided that related performance may exclude any Related Portfolios if:

- The advertised performance results are not materially higher than if all Related Portfolios had been included; and

- The exclusion of any Related Portfolio does not alter the presentation of any applicable time periods prescribed by the Standard Reporting Period Requirements (see above).

Methodology in Determining Related Portfolios: Whether a Portfolio is a "Related Portfolio" requires a facts and circumstances analysis. For example, an adviser may determine that a portfolio with material client constraints or other material differences, for example, does not have substantially similar investment policies, objectives, and strategies and should not be included as a Related Portfolio. On the other hand, different fees and expenses alone would not allow an adviser to exclude a Related Portfolio that has a substantially similar investment policy, objective, and strategy as those of the services offered.

Presenting Related Performance on a Portfolio-by-Portfolio Basis: Presenting Related Performance on a Portfolio-by-Portfolio basis will be subject to the Seven Principles. For example, an Advertisement presenting Related Performance on a Portfolio-by-Portfolio basis could be potentially misleading if it does not disclose the size of the Portfolios and the basis on which the adviser selected the Portfolios.

Use of Composites: An adviser may only have one composite aggregation for each stated set of criteria. The Marketing Rule does not permit advisers to create more than one composite aggregation of all portfolios falling within a stated set of criteria. Once the criteria are established, all Related Portfolios meeting the criteria must be included in the composite.

- Standard Reporting Periods (Excludes Private Fund Performance Reporting)

Under the Marketing Rule, an Advertisement containing performance results of any portfolio or any composite aggregation of Related Portfolios must include performance results of the same portfolio or composite aggregation for one (1)-, five (5)-, and ten (10)-year periods, each presented with equal prominence and ending on a date that is no less recent than the most recent calendar year-end. If the relevant portfolio did not exist for a particular prescribed period, then the life of the portfolio should be substituted for that period.

It is important to note that these one(1)-, five (5)-, and ten (10)-year standard reporting period requirements do not apply to the presentation of private fund performance in Advertisements.

Advertisements may still contain other performance periods (e.g., quarter-end, month-end, three-year, etc.) as long as the relevant one (1)-, five (5)-, and ten (10)-year periods are included. For Advertisements drafted at the beginning of the year where the prior calendar year-end information is not yet available, the adviser should use the most recent data available at the time (e.g., either month-end November data or third quarter data if that is the most recent data available).

- Hypothetical and model performance

Historically, advisers have largely steered clear of, or treaded very carefully when, including hypothetical performance in advertisements, perhaps given active enforcement interests in such use. In the Marketing Rule, hypothetical performance is defined to include, generally, performance results that were not actually achieved by any portfolio of the adviser, including model performance, back-tested performance, targeted, or projected performance returns. The SEC stated that actual performance of the adviser's proprietary portfolios and seed capital portfolios are not hypothetical performance (provided it does not become a means of doing indirectly what cannot be done directly, e.g., by investing nominal seed capital). Interactive analytic tools and predecessor performance (addressed separately) are not covered by the provisions addressing hypothetical performance.

The Marketing Rule prohibits presentations of hypothetical performance in Advertisements unless the following conditions are met:

- The adviser has adopted and implemented policies and procedures reasonably designed to ensure that the hypothetical performance information is relevant to the likely financial situation and investment objectives of the intended audience;

- The adviser must provide sufficient information to enable the intended audience to understand the criteria used and assumptions made in calculating such hypothetical performance; and

- The adviser must provide sufficient information to enable the intended audience to understand the risks and limitations of using hypothetical performance in making investment decisions.

The SEC made clear that Advertisements with hypotheticals can only be distributed to investors (and, presumably, prospective and existing clients) who have access to the resources to independently analyze this information and who have the financial expertise to understand the risks and limitation of these types of presentations. While not explicitly a limitation that these kinds of Advertisements can only be distributed to institutions and consultants, it would seem that such advertisements should not be provided to any kind of retail audience.[148]

- Use of carve-outs or extracted performance

Another industry practice that developed over time is presenting performance of a segment of subset of one or more portfolios. For example, an adviser providing a balanced strategy of investing in equity and fixed income securities would often split the balanced portfolios and show the performance of the equity or the fixed income components of the portfolios as a stand-alone basis, with disclosure.

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[148] The SEC enforcement actions derived since the Marketing Rule's compliance date in November 2021 have mainly focused on advisers inappropriately including hypothetical performance on publicly available websites and not having sufficient policies and procedures covering the hypothetical performance intended audience requirements. *See* SEC Press Release: SEC Charges Five Investment Advisers for Marketing Rule Violations (Apr. 12, 2024); Advisers Act Release No. 6585 (April 12, 2024); Advisers Act Release No. 6586 (April 12, 2024); Advisers Act Release No. 6587 (April 12, 2024); Advisers Act Release No. 6588 (April 12, 2024); and Advisers Act Release No. 6589 (April 12, 2024). This first set of cases also involved the advisory firms advertising on their public websites hypothetical performance in the form of model and/or back-tested performance, resulting in civil penalties ranging from $50,000 to $175,000, for a combined total of $850,000. *See also* SEC Press Release: SEC Sweep into Marketing Rule Violations Results in Charges Against Nine Investment Advisers (Sep. 11, 2023), and related Advisers Act releases. The first Marketing Rule enforcement action was brought in August 23, 2021, and involved an adviser's improper use of hypothetical performance metrics in an Advertisement (*see* Mayer Brown Legal Update, US SEC Brights First "Marketing Rule" Action: A Return to Rulemaking by Enforcement? (Aug. 29, 2021)).

Under the Marketing Rule, extracted performance is permitted, subject to certain requirements. First, extracted performance under the rule refers only to the performance of a subset of a single portfolio, not multiple portfolios (the latter would be treated as hypothetical performance). An adviser that presents extracted performance in an Advertisement must also provide, or offer to provide promptly, the performance results of the total portfolio from which the performance was extracted, with disclosure. The SEC did not provide clear guidance on how to account for cash in the extracted performance, and, instead, left that treatment to be disclosed. In addition, the Marketing Rule requires that if extracted performance is shown on a gross of fees/expenses basis, it must also be presented net of fees for the applicable subset of investments extracted from a portfolio.

That said, in a March 2025 FAQ, the IM Staff provided relief from the net performance requirement for both extracted performance from a single portfolio as well as extracted performance from a composite of all related portfolios, subject to a number of conditions (as outlined below):[149]

- The extracted performance must be clearly identified as gross performance.
- The extracted performance must be accompanied by total portfolio gross/net performance that is calculated/presented in compliance with the Marketing Rule (which could be a representative account or a composite, and presumably must be actual not hypothetical performance).
- The total portfolio return information must be at least as prominent as the extracted performance, and must facilitate comparison to the extracted performance.
- Total portfolio performance must be for a period of at least as long as the period covered by the extracted performance. However, recognizing that the time periods over which extracts are calculated may not easily align with the time periods required by Rule 206(4)-1(d)(2), the SEC staff guidance permits the extracted performance to be calculated over a single, clearly disclosed period, even if the accompanying gross and net performance of the total portfolio must be presented over one (1)-, five (5)-, and ten (10)-year periods.

Regarding the third condition, notably, under this new guidance, the gross and net performance of the total portfolio does not necessarily need to be presented on the same page of the advertisement as the extracted performance—as long as the presentation facilitates a comparison between the gross and net performance of the total portfolio and the extracted performance. For example, in the SEC staff's view, presenting the gross and net performance of the total portfolio prior to the extracted performance in the advertisement could also facilitate such comparisons and help ensure they are presented with at least equal prominence to the performance of the extract.

In caution, the SEC staff noted that any advertisement that presents the gross performance of one or more extracts in reliance on this guidance remains subject to the general prohibitions of Rule 206(4)-1(a) (as well

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[149] SEC Division of Investment Management, Marketing Compliance Frequently Asked Questions (Mar. 19, 2025); *see also*, Mayer Brown Legal Update, Past Guidance No Assurance of Future Guidance: SEC Staff Reverses Course with New Marketing Rule FAQs on Extracted Performance (Mar. 21, 2025). In the IM Staff's prior version of this FAQ, the SEC staff stated that extracted performance must be shown on a net basis in accordance with the requirements of the Marketing Rule. However, the industry found that in many circumstances, the calculation of extracted net performance was challenging, if not close to impossible, and resulted in extracted performance presentations that were confusing and, some could argue, misleading, often relying on a number of stated assumptions in order to calculate a theoretical "net" performance figure for the extract. Recognizing these challenges, the IM Staff reversed course with this updated FAQ.

as sections 206(1) and 206(2) of the Advisers Act); accordingly, advisers should bear in mind that the Updated Extracted Performance FAQ does not create a free-for-all for cherry-picking and similar issues that would run afoul of the general "fair and balanced" and other requirements.[150]

- Use of performance achieved at predecessor advisers

Another common industry practice that advisers engage in involves hiring individuals or teams from other investment advisers and advertise the performance achieved by the individuals or team at the predecessor firm. The Marketing Rule defines this as the presentation of "predecessor performance," which means investment performance achieved by a group of investments consisting of an account or a private fund that was not advised at all times during the period shown by the adviser advertising the performance.

A set of conditions applicable to use of "ported" or predecessor performance has evolved from SEC staff no-action letters that have largely been codified into the Marketing Rule. These conditions are:

- The person(s) who were primarily responsible for achieving the prior performance results manage accounts at the advertising adviser;

- The accounts managed at the predecessor adviser are sufficiently similar to the accounts managed at the advertising adviser that the performance results would provide relevant information;

- All accounts that were managed in a substantially similar manner are advertised unless the exclusion of any accounts would not result in materially higher performance and the exclusion of any account does not alter the presentation of the Marketing Rule's standard reporting periods (if applicable); and

- The Advertisement clearly and prominently includes all relevant disclosures, including that the performance results were from accounts managed at another entity.

An adviser that includes predecessor performance in Advertisements also has to include performance of its accounts that are Related Portfolios to those groups of investments depicted in the predecessor performance. For example, if the lifted-out team manages accounts in a large cap equity strategy and that team joins a large cap equity adviser, in order for the acquiring adviser to include the performance of the team at its predecessor firm, it must also include Related Performance (if any) of its own large cap equity accounts.[151]

f) Third-Party Ratings

The Marketing Rule defines a third-party rating as a rating or ranking of an investment adviser provided by a person who is not a "related person" (as defined in the Form ADV glossary of terms) and such person provides such ratings or rankings in the "ordinary course of its business." The SEC believes that the ordinary

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[150] SEC Division of Investment Management, Marketing Compliance Frequently Asked Questions (Mar. 19, 2025); *see also*, Mayer Brown Legal Update, Past Guidance No Assurance of Future Guidance: SEC Staff Reverses Course with New Marketing Rule FAQs on Extracted Performance (Mar. 21, 2025).

[151] An adviser using predecessor performance in Advertisements should also be mindful of the related recordkeeping under Rule 204-2, which require retention of documentation of communications relating to predecessor performance and complete records to support the performance calculations. Each of these records will be required to be maintained in the same manner, and for the same period of time, as other books and records required to be maintained under rule 204-2(a).

course of business requirement would largely correspond to persons with the "experience to develop and promote ratings based on relevant criteria."[152]

An Advertisement cannot include a third-party rating unless the investment adviser:

- Has a "reasonable basis" for believing that any questionnaire or survey used in the preparation of the third-party rating 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 (due diligence requirement); and

- Clearly and prominently discloses (or the investment adviser "reasonably believes" that the third-party rating clearly and prominently discloses (disclosure requirement)):

    - The date on which the rating was given and the period of time upon which the rating was based;

    - The identity of the third party that created and tabulated the rating; and

    - If applicable, that compensation (including, importantly, in a form other than cash) has been provided directly or indirectly by the investment adviser in connection with obtaining or using the third-party rating.

To satisfy the due diligence requirement, the adviser cannot rely solely on the results of a survey or questionnaire, i.e., the rating itself; the adviser must conduct some due diligence into the underlying methodology and structure.[153]

Regarding the disclosure requirement, the SEC warned that, although the rule requires the specific disclosures above, those disclosures would not cure a rating that could otherwise be false or misleading under the Seven Principles or under the general anti-fraud provisions of the federal securities laws. The SEC provided two examples:

- Where an adviser's advertisement references a recent rating and discloses the date, but the rating is based upon an aspect of the adviser's business that has since materially changed, the advertisement would be misleading.

- An adviser's advertisement would be misleading if it indicates that the adviser is rated highly without disclosing that the rating is based solely on a criterion, such as assets under management, that may not relate to the quality of the investment advice.

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[152] The SEC noted that the ordinary course of business requirement also distinguishes third-party ratings from testimonials and endorsements that resemble third-party ratings, but that are not made by persons who are in the business of providing ratings or rankings.

[153] The SEC believes that an adviser could satisfy the due diligence requirement by accessing the questionnaire or survey that was used in the preparation of the rating, obtain representations from the third party regarding general aspects of how the survey or questionnaire was designed, structured, and administered, or access publicly available information from the third party regarding its survey or questionnaire methodology. As a result, the SEC believes that an adviser could obtain sufficient information to formulate a reasonable belief as required by the due diligence requirement without obtaining proprietary data of third-party rating agencies.

The SEC expressed its belief that a rating by an affiliated person might otherwise be prohibited under the Seven Principles, depending on the facts and circumstances ("[t]he requirement that the provider not be an adviser's related person will avoid the risk that certain affiliations could result in a biased rating"). As a result, presumably the SEC's view is that the rule prohibits advisers from using related person ratings in their advertisements.[154]

g) Marketing and Advertising Issues

Private Offerings – For years, the SEC prohibited advisers to private funds from engaging in public advertising as a result of the interaction between the long-standing ban on general solicitations of private offerings under Regulation D, the private placement rules under the 1933 Act, and Company Act Sections 3(c)(1) and 3(c)(7) governing private funds. However, under the JOBS Act, the SEC was directed to adopt rules that would allow private funds (among others) to advertise publicly.[155] The SEC issued proposed rules on August 29, 2012, and adopted the rules on July 10, 2013.[156] The adopting release recognized that private funds relying on Sections 3(c)(1) and 3(c)(7) could make use of the new public advertising regime without losing their ability to rely on those exclusions.[157]

"Strategy-Washing" – The SEC and its staff historically have scrutinized whether investment advisers are managing client assets in a manner consistent with their advertisements and disclosures, particularly where the claimed strategies are new and otherwise trendy. Notable examples in recent years include heightened regulatory interest—including enforcement actions—in investment advisers' claims regarding topics ranging from ESG (including so-called "green-washing"),[158] social or religious considerations,[159] and "robo," quantitative, and similar algorithmic-based strategies and services.[160] In each case, the bottom line for the

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[154] While the Marketing Rule adopting release did not explicitly prohibit use of related person ratings, it would seem that any such rating would need substantial disclosure to overcome an assumption that it is heavily biased in favor of the adviser affiliate and almost per se misleading.

[155] *See* Section 201(a) of the Jumpstart Our Business Startups Act, Pub. L. No. 112–106 (Apr. 5, 2012), 126 Stat. 306, at 313.

[156] *See* Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Release Nos. 33-9415, 34-69959, IA-3624 (Jul. 10, 2013) (final rule); *see also* Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Release No. 33-9354 (Aug. 29, 2012) [hereinafter Rules 506 and 144A Proposing Release] (notice of proposed rulemaking).

[157] *See* Rules 506 and 144A Proposing Release, at 32 ("We historically have regarded Rule 506 transactions as non-public offerings for purposes of Sections 3(c)(1) and 3(c)(7). We believe the effect of [JOBS Act] Section 201(b) is to permit privately offered funds to make a general solicitation under amended Rule 506 without losing either of the exclusions under the Investment Company Act.").

[158] *See In re* WisdomTree Asset Management Inc., Release No. 6753 (Oct. 21, 2024) and *In re* Invesco Advisers, Inc., Release No. 6770 (Nov. 8, 2024).

[159] *See In re* Inspire Investing, LLC Release No. 6710 (Sep. 19, 2024); *see also*, *In re* Wahed Invest, LLC Release No. 6763 (Nov. 1, 2024). In *Wahed Invest*, an adviser claimed to advertise the existence of its own proprietary funds, but those funds did not exist. Eventually, adviser did launch a proprietary ETF in July 2019; it used its clients' advisory assets to seed the ETF without prior disclosure to clients of any conflicts of interest. Additionally, adviser claimed to make investments in accordance with *Shari'ah* law, but adopted no policies to ensure *Shari'ah* compliance on an ongoing basis.

[160] *See In re* Rimar Capital USA, Inc., Rimar Capital, LLC, Itai Liptz, and Clifford Boro, Release Nos. 11316, 101297, 6745, and 35357 (Oct. 10, 2024). In this proceeding, Liptz, owner and CEO of Rimar LLC and Rimar USA, with the help of Boro, a Rimar USA board member, raised nearly $4 million from 45 investors. To accomplish this, Liptz and Boro (1) falsely described Rimar LLC, an investment adviser, as having an AI-driven platform for trading securities, and (2) overstated Rimar LLC's assets under management and investment returns. Fund executives, among other things, purported to use artificial intelligence to perform automated trading for advisory client accounts in a range of products including equities, futures, and crypto assets—and, in fact, had no such capabilities or practices for trading.

SEC and its staff was that the advisers' statements to investors and clients about their strategies were not consistent with the manner in which the advisers were actually managing their assets. Whether it is AI-washing, green-washing, or quant-washing, the regulatory message is the same—say what you do and do what you say, as further demonstrated by SEC enforcement actions. In terms of recent examples, in 2024, the SEC charged two investment advisers with violations of, among other things, Advisers Act Rule 206(4)-1, the Marketing Rule, for disseminating advertisements that included untrue statements of material fact or otherwise omitted material facts necessary to make the advertisements not misleading under the circumstances.[161]

2. Custody of Client Assets: Rule 206(4)-2

As a result of the now notorious Madoff scheme,[162] the SEC amended Rule 206(4)-2 ("Custody Rule") in 2009 to strengthen the protection of client assets subject to adviser custody. The Custody Rule provides that it is a fraudulent and deceptive business practice for an adviser to have custody of client funds or securities unless the adviser: (a) maintains such assets with a "qualified custodian"; (b) reasonably believes, after due inquiry, that the qualified custodian provides clients with quarterly account statements; and (c) undergoes a surprise examination by an independent public accountant.[163] In addition, advisers that maintain custody of client funds or securities with an affiliated qualified custodian (or maintain self-custody as a qualified custodian) are required to obtain an "internal control report" from their affiliate (or for themselves, in the case of self-custody). The 2009 amendments to the Custody Rule demonstrated a marked change from the previous rule, most notably requiring many advisers to undergo an annual surprise examination.

Under the Custody Rule, an adviser has "custody" if it, or a "related person" "hold[s] directly or indirectly client funds or securities, or ha[s] any authority to obtain possession of them."[164] A "related person" is any person, directly or indirectly, controlling, controlled by, or under common control with, the adviser.[165] The Custody Rule provides three examples of situations in which an adviser may be deemed to have custody:

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[161] Press Release, SEC, SEC Charges Two Investment Advisers with Making False and Misleading Statements About Their Use of Artificial Intelligence (Mar. 18, 2024); see also *In re* Delphia (USA) Inc., Release No. 6573 (Mar. 18, 2024); and *In re* Global Predictions Inc., Release No. 6574 (Mar. 18, 2024).

[162] *See* companion criminal and civil complaints, *United States v. Bernard L. Madoff,* and *SEC v. Bernard L. Madoff and Bernard L. Madoff Investment Securities LLC*, S.D.N.Y. (Dec. 11, 2008). Mr. Madoff pled guilty to all 11 counts of the criminal complaint in Manhattan's federal district court on March 12, 2009.

[163] *See* Custody of Funds or Securities of Client by Investment Advisers, Release No. IA-2968 (Dec. 30, 2009); *see also* Custody of Funds or Securities of Client by Investment Advisers, Release No. IA-2176 (Oct. 1, 2003). The SEC has shown increased interest in advisers' compliance with the Custody Rule. On October 28, 2013, the SEC issued three administrative orders related to advisers' violations of the Custody Rule, explaining that "other firms who hold client assets should take notice that [the SEC] will vigorously enforce such requirements." Press Release, SEC, SEC Charges Three Firms with Violating Custody Rule (Oct. 28, 2013); *see also* GW & Wade, LLC, Release No. IA-3706 (Oct. 28, 2013); Further Lane Asset Mgmt., LLC, Release Nos. 34-70759, IC-30767, IA-3707 (Oct. 28, 2013); Knelman Asset Mgmt. Grp., LLC, Release Nos. IC-30766, IA-3705 (Oct. 28, 2013). In 2017, OCIE issued a risk alert providing examples of typical deficiencies in Custody Rule compliance by advisory firms, which were identified by OCIE examiners, such as the following: advisers did not recognize that they may have custody due to online access to client accounts; advisers with custody obtained surprise examinations that did not meet the requirements of the Custody Rule; and advisers did not recognize that they may have custody as a result of certain authority over client accounts. OCIE, National Exam Program, Risk Alert: The Five Most Frequent Compliance Topics Identified in OCIE Examinations of Investment Advisers (Feb. 7, 2017).

[164] Rule 206(4)-2(d)(2).

[165] Rule 206(4)-2(d)(7).

- *Possession or control of client funds or securities.* An adviser who inadvertently receives client assets has three days to return them without being deemed to have custody.

- *Authority to withdraw funds.* Any arrangement permitting an adviser (or its related person) to withdraw client funds or securities upon instruction to the custodian.[166] In a February 2017 Guidance Update regarding custody, the SEC Staff cautioned advisers of potential situations where advisers may have inadvertent custody of client funds and securities due to broad provisions in certain custodian agreements between the client and custodian.[167] These include:

    - a custodial agreement that grants the client's adviser the right to "receive money, securities, and property of every kind and dispose of same."

    - a custodial agreement under which a custodian "may rely on [adviser's] instructions without any direction from [client]. [Client] hereby ratifies and confirms any and all transactions with [the custodian] made by [adviser] for [client's] account."

    - a custodial agreement that provides authorization for the client's adviser to "instruct us to disburse cash from [client's] cash account for any purpose . . . ."

    - custodial arrangements that are not processed or settled on a delivery versus payment ("Non-DVP") basis.[168]

  The 2017 Custody Guidance Update continued to state that the Staff believes an adviser would have custody if the custodial agreement authorizes the adviser to withdraw client funds or securities, notwithstanding provision(s) in the advisory agreement to the contrary. However, it also described a potential solution to avoid such inadvertent custody, by drafting a letter (or other form of document) addressed to the custodian that limits the adviser's authority to "delivery versus payment," notwithstanding the wording of the custodial agreement, and to have the client and custodian provide written consent to acknowledge the new arrangement.[169]

- *Legal ownership of client funds or securities.* Advisers that act as general partners or managing members to pooled investment vehicles, or act as trustees to advisory client trusts (or have employees that act as such), are deemed to have custody. Advisers to such vehicles may comply

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[166] An adviser was found to have custody of client funds by its use of pre-signed authorization letters that the adviser used to transfer the client funds without a contemporaneous client signature. The SEC observed that the use of pre-signed letters coupled with a lack of procedures for authentication had exposed the adviser's clients to potential fraud. *See GW & Wade, LLC*, at 2.

[167] IM Guidance Update No. 2017-01, Inadvertent Custody: Advisory Contract versus Custodial Contract Authority (Feb. 2017) (the "2017 Custody Guidance Update").

[168] *Id.* In December 2018, the SEC Staff granted conditional no-action relief to an administrative agent for syndicated loans that also acted (or that had affiliates that also acted) as an investment adviser for pooled investment vehicles or separately managed accounts that are also lenders under such syndicated loans. Madison Capital Funding LLC, SEC No-Action Letter (Dec. 20, 2018). The administrative agent sought no-action relief due to its ability to access the assets of the loan syndicate on an other-than-DVP basis, and it also was concerned that because it typically established a single bank account for all participants in a loan syndicate, the arrangement would fail to comply with certain other requirements under the Custody Rule. The SEC Staff granted no-action provided the administrative agent complied with 11 different conditions, a full discussion of which is described in the above linked no-action letter. *Id; see also* Mayer Brown Legal Update, SEC Grants Conditional No-Action Relief from the Custody Rule for Certain Administrative Agents under Syndicated Loans (Dec. 26, 2018).

[169] 2017 Custody Guidance Update at 2.

with the Custody Rule either by: (1) undergoing an annual surprise examination (performed by an independent public accountant registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board ("PCAOB")) and forming a reasonable basis for believing that the qualified custodian delivers quarterly account statements to each investor in the vehicle, or (2) delivering to all fund investors annual financial statements audited by an independent public accountant registered with, and subject to regular inspection by, the PCAOB, in accordance with (or, under certain circumstances, reconciled to) US generally accepted accounting principles, within 120 days (180 days for funds of funds) after the end of the pooled vehicle's fiscal year ("Audit Method").[170] Failing to deliver audited financial statements within the 120-day window (e.g., 40 days late) may result in an SEC enforcement action against the adviser and its principals and CCO.[171] Additionally, the SEC will impose more severe penalties on advisers that fail to correct their Custody Rule violations after being notified by SEC staff of such violations (e.g., deficiency letters or prior settlement orders).[172] Pooled investment vehicles using the Audit Method are also required to undergo a "liquidation audit" upon liquidation of the vehicle.

As discussed above, the Custody Rule requires that client funds and securities be held by a "qualified custodian," which includes domestic banks, custodying broker-dealers and futures commission merchants (but only for futures positions), and certain foreign financial institutions. The adviser must inform its clients of the identity of the qualified custodian and the manner in which their assets are being custodied, and must update the client if that information changes. Clients must receive quarterly account statements from the qualified custodian. If the adviser also sends account statements itself, it must include a legend on each such account statement urging clients to compare the account statements received from the custodian with those received from the adviser. Advisers with custody must also undergo an annual surprise examination and file Form ADV-E in connection with that surprise examination.[173] This surprise examination requirement does *not* apply to advisers who have custody solely because they have authority to deduct fees, nor to

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[170] The SEC settled an administrative proceeding against an adviser to private funds, which had stated in private placement memoranda that its financial statements were prepared in accordance with generally accepted accounting principles ("GAAP"). However, when the adviser had information that certain private fund holdings had no value or no significant value compared to their cost-based value, the adviser wrongly provided financial statements that valued holdings at acquisition cost, rather than at fair value, which was inconsistent with GAAP requirements. *In re* Retirement Inv. Advisors, Inc., Release Nos. 34-76218, IA-4237 (Oct. 21, 2015).

[171] On November 19, 2015, the SEC settled an administrative proceeding against an investment adviser firm, its co-founders, and its CCO, for the firm's repeated failures to comply with the Custody Rule and the terms of a 2010 settlement order with the SEC. *In re* Sands Bros. Asset Mgmt., LLC, Release No. IA-4273 (Nov. 19, 2015) (imposing a $1 million penalty jointly on the principals and a one-year suspension for their awareness of the firm's deficiencies with respect to Custody Rule compliance, role in the audit process, and responsibility for implementing policies and procedures to ensure the firm's compliance with the Advisers Act); *In re* Christopher Kelly, Release No. IA-4274 (Nov. 19, 2015) (imposing a $60,000 penalty and a one-year suspension on Kelly, the CCO, COO, and partner of the firm, for his awareness of the firm's deficiencies with respect to Custody Rule compliance, role in the audit process, responsibility for implementing policies and procedures to ensure compliance with the Custody Rule, and failure to notify the SEC staff of the firm's difficulties in meeting the Custody Rule deadlines). In 2018, the SEC settled two administrative proceedings against private equity advisory firms that allegedly violated the Custody Rule each and every year since they registered with the SEC in 2012. *See In re* New Silk Route Advisors LP, Release No. IA-4970 (Jul. 17, 2018) (the adviser failed to distribute annual audited financial statements to the limited partners of certain managed funds within the required timeframes for every fiscal year since the adviser's initial registration in 2012); and *In re* Hudson Housing Capital LLC, Release No. IA-5047 (Sep. 25, 2018).

[172] Press Release, SEC, Custody Rule Violators Settle Charges (Nov. 19, 2015) (statement by Andrew M. Calamari, Director of the SEC's New York Regional Office); *see also*, *In re* ACP Venture Capital Management Fund LLC (Sep. 20, 2024).

[173] Form ADV-E filings consist of (i) a cover page and (ii) a certificate of accounting (surprise examination report or termination statement) of securities and funds in possession or in an investment adviser's custody.

advisers whose only clients are private funds using the Audit Method or registered investment companies. It does apply when an adviser's related person that is not operationally independent maintains custody of client funds or securities. The Custody Rule requires an independent accounting firm, in connection with performing a surprise examination, to notify the SEC's Division of Examinations within one day of finding "any material discrepancies during the examination." Right after the Custody Rule was amended, the SEC's Office of the Chief Accountant issued guidance to the accountants performing these surprise exams and stated that the duty to notify the SEC was triggered "upon finding *any material non-compliance with the provisions of Rule 206(4)-2 or Rule 204-2(b*)." [174] Although the issuance of this guidance statement was not published for comment, it continues to be followed by accounting firms when they perform Custody Rule surprise examinations.

The amended Custody Rule changed the exception for privately offered securities, which are now excepted only from the qualified custodian requirement. For pooled investment vehicles, this exception is only available if they use the Audit Method.[175] Advisers who do not use the Audit Method for the pooled investment vehicles they manage may be required to identify a qualified custodian willing to maintain custody of such securities, and to include them on all quarterly account statements sent to investors. Under a 2012 SEC staff no-action letter, advisers to state college tuition plans, or 529 Plans, can rely on the Audit Method to satisfy the Custody Rule to the same extent as pooled investment vehicles.[176]

The Custody Rule does not apply to registered investment company clients. Mutual fund shares held in advisory client accounts may be held by the fund's transfer agent in lieu of a qualified custodian, provided all other requirements under the Custody Rule are met — notably, if the fund's transfer agent is a related person of the adviser, the adviser is required to obtain an internal control report from the transfer agent.

Under the amended Custody Rule, an adviser is presumed to have custody of client funds and securities if a related person has custody of those funds and securities. Similarly, the SEC has taken the position that an adviser has custody when that adviser operates as a "single integrated adviser" with other advisers, each of which shares a common control person who has the authority to obtain possession of client assets (i.e., has custody).[177] However, under certain circumstances, an adviser may overcome this presumption if it is "operationally independent" of its related person and may thus avoid undergoing a surprise exam. Nonetheless, this would not relieve the adviser of a requirement to obtain an internal control report if the

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[174] Investment Advisers Act Release No. 2969 (Dec. 30, 2009), at page 5 (emphasis added).

[175] The SEC staff extended the relief for privately offered securities to private certificated securities under certain conditions. According to the staff guidance, an adviser to a pooled investment vehicle ("PIV") does not have to maintain private stock certificates with a qualified custodian, so long as: (1) the PIV uses the Audit Method; (2) the certificate is used solely to effect or facilitate a change in the beneficial ownership of the security with the prior consent of the security's holder or issuer; (3) ownership of the security is recorded under the PIV's name on the books of the issuer or transfer agent; (4) the certificate has a legend that restricts transfer; and (5) the adviser has "appropriately safeguarded" the certificate and can replace the certificate if lost or destroyed. *See* Privately Offered Securities under the Investment Advisers Act Custody Rule, IM Guidance Update No. 2013-04, at 2 (Aug. 2013).

[176] *See* Investment Co. Institute, SEC No-Action Letter (Sep. 5, 2012).

[177] Advisers may be deemed to be operating as a single integrated adviser for purposes of the Custody Rule, when they have significant ownership overlap, operational overlap, capitalization overlap, advisory overlap, and fail to conduct themselves as separate entities and to respect corporate formalities. *In re* Reid Johnson, Release Nos. 34-75626, IA- 4161, IC- 31743 (Aug. 6, 2015).

related person acts as qualified custodian. Using criteria harvested from an old staff no-action letter,[178] the Custody Rule provides that an adviser may overcome the presumption if:

- client assets in the custody of the related person are not subject to claims of the adviser's creditors;
- advisory personnel do not have custody or possession of, or direct or indirect access to client assets of which the related person has custody, or the power to control the disposition of such assets to third parties for the benefit of the adviser or its related persons, or otherwise have the opportunity to misappropriate such client assets;
- personnel of the adviser and its related person who have access to advisory client assets are not under common supervision;
- advisory personnel do not hold any position with, or share premises of, the related person; and
- no other circumstances can reasonably be expected to compromise the operational independence of the related person.[179]

Pursuant to Staff relief which was not affected by the 2009 Custody Rule amendments, if client assets are received from certain "third parties," the adviser has five business days from receipt to forward the assets to its client or the client's qualified custodian.[180] Relevant "third parties" are (1) state and federal tax authorities who send client tax refunds to advisers who completed and filed tax forms for clients; (2) distributors of class action or similar settlement proceeds to advisers who filed proofs of claim for clients; and (3) issuers of stock certificates or dividend checks in clients' names. Advisers must use still reasonable best efforts to direct such third parties to deliver client assets directly to the client or its custodian. Advisers that inadvertently receive client assets from such third parties on more than rare occasions are expected to adopt and implement written safekeeping procedures which ensure prompt:

- identification of client assets that are inadvertently received;
- identification of clients (or former clients) to whom assets are attributable;
- forwarding of client assets to clients (or former clients) or qualified custodians, but in no event later than five business days following advisers' receipt of such assets;
- return to the appropriate third party of any inadvertently received assets not forwarded to clients (or former clients) or qualified custodians, but in no event later than five business days following advisers' receipt; and

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[178] *See* Crocker Investment Mgmt. Corp., SEC No-Action Letter (Apr. 14, 1978).

[179] Rule 206(4)-2(d)(5). Advisers relying on operational independence to avoid undergoing a surprise examination are also required to make and keep a memorandum describing the relationship with the related person in connection with advisory services the adviser provides to clients and including an explanation of the adviser's basis for determining that it has overcome the presumption that it is not operationally independent of the related person with respect to the related person's custody of client assets. Rule 204-2(b)(5).

[180] *See* Investment Adviser Ass'n, SEC No-Action Letter (Sep. 20, 2007).

- recordkeeping.

On February 15, 2023, SEC proposed a new rule for registered investment advisers that would replace the current "custody rule" under the Advisers Act with a new "safeguarding rule" and make corresponding amendments to the Adviser Act's recordkeeping rule and Form ADV.[181]

Among other things, the new "safeguarding" rule would:

- significantly expand the scope of the types of client assets covered under the rule from "funds and securities" to include any client assets of which an adviser has custody (including non-securities assets, such as real estate, that are considered to be within the scope of the investment advisory relationship);
- broadly revise the definition of "custody" to include any client assets over which an adviser exercises discretionary trading authority; and
- require registered investment advisers to enter into a written agreement with the qualified custodian that contains terms addressing recordkeeping, client account statements, internal control reports, and the adviser's agreed-upon level of authority to effect transactions in the account.

Although the proposed rule would include a limited exception from the surprise examination requirement (retained from the current rule) for a registered investment adviser whose custody of client assets arises solely from discretionary authority, that exception is conditional. To rely on this exception:

- the client assets must be maintained with a qualified custodian (e.g., securities not kept with a custodian pursuant to the "privately offered securities" exception would be disqualified from this exception), and
- the adviser's trading under discretionary authority is limited to client assets that settle exclusively on a "delivery-versus-payment" ("DVP") basis.

Notably, by proposing to expand "custody" to include assets traded under discretionary trading authority, the proposed rule would require substantially all registered investment advisers to comply with the safeguarding rule, including its surprise examination requirement (or through delivery of annual audited financial statements in lieu of a surprise examination, as permitted under the rule).

The amended rule, "Safeguarding Client Assets," renumbered as Advisers Act Rule 223-1, is still in proposed state and the summary of the changes described above have not been adopted or become effective. On August 23, 2023, the SEC reopened the comment period on the amended rule.[182] Given the change in administration in the U.S., while amendments to the custody rule are still expected to remain on the rulemaking agenda, it is likely that any such amendments would be re-proposed prior to adoption.

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[181] Investment Advisers Act Release No. 6240 (Feb. 15, 2023).

[182] Investment Advisers Act Release No. 6384 (Aug. 23, 2023).

3. Financial and Disciplinary Disclosures: Former Rule 206(4)-4

Concurrent with the adoption of the Form ADV Part 2, the SEC rescinded Advisers Act Rule 206(4)-4. However, the fundamental requirements set forth in the rescinded Rule were incorporated into Items 9 and 18 of Part 2 and the fundamental requirements of the Rule were incorporated into the instructions associated with those disclosure items. Item 9 requires disclosure of disciplinary information and Item 18 requires disclosure of financial information. As such, all investment advisers are still required to disclose all material facts with respect to:

- a financial condition of the adviser that is reasonably likely to impair the ability of the adviser to meet its contractual commitments to clients if the adviser has discretionary authority (expressed or implied) *or* custody over client assets *or* requires prepayment of advisory fees of more than $1200 from each client, six months or more in advance (*prompt* disclosure to clients or prospective clients of all material facts required); or

- any legal or disciplinary event that is material to an evaluation of the adviser's integrity or ability to meet contractual commitments to clients.

There is a rebuttable "presumption of materiality" for certain defined legal or disciplinary events, occurring within the prior 10 years, involving the adviser or any *management person* of the adviser. These include adverse civil and criminal court actions generally involving fraud or theft, certain findings in federal and state administrative proceedings, and administrative or self-regulatory organization proceedings involving findings of violations of securities or other investment-related laws and the imposition of significant sanctions.

While the standards applicable to a determination of whether a disciplinary event is "material" are not specifically addressed, in determining whether a presumptively material disciplinary event is in fact material, an investment adviser "should carefully weigh" each of the following four factors: (a) the distance of the entity or individual involved in the disciplinary event from the advisory function; (b) the nature of the infraction that led to the disciplinary event; (c) the severity of the disciplinary sanction; and (d) the time elapsed since the date of the disciplinary event.[183] Even though disclosure is now required to be made in the adviser's Brochure, the obligation to provide the required information is ongoing and may create an obligation to provide the disclosure separately or to revise the Brochure promptly and re-deliver it or a summary of the material changes to all clients.[184]

4. Pay-to-Play Rule: Rule 206(4)-5

Rule 206(4)-5 addresses advisers' "pay-to-play" practices with respect to state and local governments' public pension funds; i.e., the practice of giving gifts or political contributions to elected officials in exchange for the opportunity to manage pension plan assets.[185] The Rule came on the heels of several high-profile civil and criminal cases involving state pension funds, most notably in New York. The Rule is intended to curb pay-to-play abuses with respect to government funds by limiting the use of third-party placement agents

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[183] *See* Financial and Disciplinary Information That Investment Advisers Must Disclose to Clients, Release No. IA-1083 (Dec. 1, 1987).

[184] *See In re* Beverly Hills Wealth Management, LLC, Release No. IA-4975 (Jul. 20, 2018) (adviser failed to disclose precarious financial condition in its Form ADV).

[185] *See* Political Contributions by Certain Investment Advisers, Release No. IA-3043 (Jul. 1, 2010) (adopting rule); *see also* Political Contributions by Certain Investment Advisers, Release No. IA-2910 (Aug. 3, 2009) (proposing release).

by certain "regulated persons" when soliciting government funds for advisory business and by imposing limitations on certain campaign contributions. It also prohibits doing indirectly anything that cannot be done directly.

As initially adopted, the Rule applied to both registered or required to be registered advisers and advisers that are unregistered in reliance on the private adviser exemption. As a result of the repeal of the private adviser exemption, the Rule was amended in conjunction with the Dodd-Frank amendments to Form ADV.[186] In particular, the Pay-to-Play Rule was amended to make it continue to apply to advisers that previously relied on the private adviser exemption, including exempt reporting advisers (i.e., venture capital and private fund advisers) and foreign private advisers. In addition, the Rule was amended to include a new category of "regulated persons." As initially adopted, "regulated persons" included only registered investment advisers and registered broker-dealers to the extent that FINRA adopts a rule similar to the Pay-to-Play Rule for its members. As amended, the Rule now also covers municipal advisers subject to a pay-to-play rule by the Municipal Securities Rulemaking Board ("MSRB"). While the MSRB had filed a proposed rule for municipal advisers with the SEC,[187] it was withdrawn less than a month later because the SEC had not yet adopted a final definition of "municipal adviser." FINRA has not yet adopted a rule for registered broker-dealers. In May of 2012, the SEC adopted a technical amendment to the Rule's definition of "covered associate" to correct a publication error. In adopting the Dodd-Frank amendments, the SEC had proposed to change the definition of "covered associate" in Section 206(4)-5(f)(i) to include a legal entity, not just a natural person, that is a general partner or managing member of an investment adviser, but this revision was not adopted. However, the Federal Register included the change when the Rule amendment was published. The technical amendment clarifies that legal entities that are general partners or managing members of investment advisers are not "covered associates."[188] The compliance date for the third-party solicitor ban finally came into effect on July 31, 2015.[189]

Subject to certain narrow exemptions, the Pay-to-Play Rule makes it unlawful for any covered investment adviser (or certain of its officers and employees), to provide or agree to provide payment to any unaffiliated third party (including "finders," "solicitors," "placement agents," or "pension consultants") to solicit a government entity for investment advisory services. It is unlawful for advisers to receive compensation for providing advisory services to any government entity for a two-year period after the adviser or any of its "covered associates" makes a political contribution to a public official that is, or to a candidate for public office that will be, in a position to influence the award of advisory business by that government entity, even when there is no *quid pro quo* arrangement or actual intent to influence the official or candidate.[190] An

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[186] *See* ADV Release, *supra* note 68.

[187] *See* MSRB Notice 2011-46 (Aug. 19, 2011) (filing proposed Rule G-42).

[188] *See* Technical Amendment to Rule 206(4)-5: Political Contributions by Certain Investment Advisers, Release No. IA-3403 (May 8, 2012).

[189] Political Contributions by Certain Investment Advisers: Ban on Third-Party Solicitation; Notice of Compliance Date, 80 Fed. Reg. 37538 (Jun. 25, 2015).

[190] In 2017, the SEC settled enforcement actions against 10 firms for violations of the Pay-to-Play Rule. *See* Press Release, SEC, 10 Firms Violated Pay-to-Play Rule By Accepting Pension Fund Fees Following Campaign Contributions (Jan. 17, 2017). In 2018, the SEC in 2018 settled enforcement actions against 3 firms for violations of the Pay-to-Play Rule. *See In re* Oaktree Capital Management, L.P., Release No. IA-4960 (Jul. 10, 2018); *In re* EnCap Investments L.P., Release No. IA-4959 (Jul. 10, 2018); and *In re* Sofinnova Ventures, Inc., Release No. IA-4958 (Jul. 10, 2018). The 2018 enforcement actions were similar to those brought in 2017, but with a noticeable uptick in the fine amount. Notably, while in the 2017 set of enforcement actions no fine was greater than $100,000, the 2018 set of enforcement actions saw fines ranging from $100,000 to $500,000. *See also* Press Release, SEC, SEC

investment adviser to certain pooled investment vehicles in which a government entity invests, or is solicited to invest, would be treated as though the adviser were providing or seeking to provide investment advisory services directly to the government entity. For example, a two-year "time out" will be triggered after an adviser's "covered associate" makes political contributions to a gubernatorial or mayoral candidate who, if elected, would have the power to appoint members to the board of a public pension fund (i.e., influence the decision-making of that fund) for which the adviser provides or is seeking to provide advisory services, either directly or through certain funds.[191] The Pay-to-Play Rule permits the SEC to grant exemptive relief from the rule's two-year "time out" penalties under certain circumstances, and the SEC has considered several such requests.[192]

The Rule also imposes certain related recordkeeping requirements on registered investment advisers. The Staff granted no-action relief to the ICI to allow advisers to Covered Investment Pools (i.e., registered investment companies that are investment options of a plan or program of a government entity) to keep an alternative set of records for government plans due to the lack of transparency caused by investing through intermediary or "omnibus" accounts.[193] No similar relief has yet been sought for or granted to advisers to private funds.

5. Proxy Voting: Rule 206(4)-6

Rule 206(4)-6 provides that it is a fraudulent, deceptive, or manipulative act, practice or course of business within the meaning of Section 206(4) for an investment adviser to exercise voting authority with respect to client securities, unless the investment adviser: (a) adopts and implements written policies and procedures that are reasonably designed to ensure that the investment adviser votes proxies in the best interest of clients and which address material conflicts of interest that may arise between interests of the investment adviser and those of its clients; (b) describes its proxy voting policies and procedures to its clients and provides copies of such policies and procedures to its clients upon request;[194] and (c) discloses to clients how they may obtain information on how the investment adviser voted their proxies. According to the SEC staff, investment advisers should review their proxy voting policies and procedures at least annually.[195]

The SEC has found a violation of Rule 206(4)-6 where an adviser exercised voting authority over client securities without having policies and procedures reasonably designed to ensure that it voted its clients' securities in the clients' best interests.[196] The adviser adopted a policy of voting all client securities in accordance with AFL-CIO recommendations in hopes of receiving a better score from the AFL-CIO to attract

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Charges Four Investment Advisers for Pay-To-Play Violations Involving Campaign Contributions (Sep. 15, 2022); *In re Wayzata Investment Partners LLC*, Release No. IA-6590 (Apr. 14, 2024).

[191] *See* TL Ventures Inc., Release No. IA-3859 (Jun. 20, 2014).

[192] *See, e.g.*, T. Rowe Price Assocs., Inc., Release No. IA-4046 (Mar. 12, 2015) (notice); Crestview Advisors, L.L.C., Release No. IA-3997 (Jan. 14, 2015) (order); Crestview Advisors, L.L.C., Release No. IA-3987 (Nov. 13, 2014), (notice); Ares Real Estate Mgmt. Holdings, LLC, Release No. IA-3969 (Nov. 18, 2014) (order); Ares Real Estate Mgmt. Holdings, LLC, Release No. IA-3957 (Oct. 22, 2014) (notice).

[193] *See* Investment Co. Institute, SEC No-Action Letter (Sep. 12, 2011).

[194] The description may be provided in Form ADV and only needs to be a general summary of the proxy voting process. *See* Proxy Voting by Investment Advisers, Release No. IA-2106 (Jan. 31, 2003).

[195] *See* Div. of Investment Mgmt. & Div. of Corp. Fin., SEC, Staff Legal Bulletin No. 20: Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms (Jun. 30, 2014) [hereinafter Staff Legal Bulletin No. 20].

[196] *See* INTECH Investment Mgmt. LLC, Release No. IA-2872 (May 8, 2009).

new union-affiliated clients and retain current ones, without addressing or disclosing the potential conflict between those recommendations and clients that were not pro AFL-CIO.

When an adviser retains a proxy advisory firm to assist the investment adviser in its proxy voting duties, then the SEC staff has stated that the adviser has an ongoing duty to oversee the proxy advisory firm to ensure that the adviser continues to vote proxies in its clients' best interests.[197] The adviser should maintain policies and procedures that help ensure that the investment adviser continues to vote proxies in clients' best interests and that address the proxy advisory firm's conflicts of interest. Further, the SEC staff recommended that investment advisers assess whether proxy advisory firms have the capacity and competency to analyze adequately proxy issues by, for example, considering the quality of such firms' personnel and the robustness of their policies and procedures. More specifically, advisers should consider whether their proxy advisory firms have policies and procedures that (1) ensure that the information upon which such firms make voting recommendations is accurate and current and (2) identify and address conflicts of interest.

6. Compliance Programs: Rule 206(4)-7

Rule 206(4)-7 requires each registered investment adviser to adopt and implement written policies and procedures designed to prevent or detect and correct violations of the Advisers Act ("Compliance Program"), to review its Compliance Program at least annually for adequacy and effective implementation of the Compliance Program, and to designate a CCO to be responsible for administering the Compliance Program.[198]

An adviser's Compliance Program must be reasonably designed to prevent or detect and correct violations of the Act and related rules by the adviser and its supervised persons and should address, among other things: (a) portfolio management processes, including allocation of investment opportunities among clients and consistency of portfolios with clients' investment objectives and restrictions, disclosures by the adviser and applicable regulatory restrictions; (b) trading practices, including best execution, soft dollars and client directed brokerage and trade allocation; (c) proprietary trading of the adviser and personal trading activities of supervised persons; (d) outside business activities the adviser's employees;[199] (e) the accuracy of disclosures made to investors, clients, and regulators, including account statements and advertisements; (f) safeguarding of client assets from conversion or inappropriate use by advisory personnel; (g) the accurate creation and proper maintenance of required records; (h) marketing activities, including the use of solicitors; (i) valuation of assets and fee billing;[200] (j) safeguarding the privacy of client records and information; (k) the

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[197] *See* Staff Legal Bulletin No. 20.

[198] *See* Compliance Programs of Investment Companies and Investment Advisers, Release No. IA-2204 (Dec. 17, 2003).

[199] *See In re* BlackRock Advisors, LLC, Release Nos. IA-4065, IC-31558 (Apr. 20, 2015).

[200] *See, e.g.*, *In re* Covenant Financial Services, LLC, Release No. IA-4672 (Mar. 29, 2017); *In re* Pacific Investment Management Company, LLC, Release No. IA-4577 (Dec. 1, 2016).

receipt of gifts and entertainment;[201] and (l) business continuity plans and transition plans.[202] A single, unified compliance manual is not required as long as all matters applicable to the adviser are addressed in some form; it may be sufficient "to allocate responsibility within the organization for the timely performance of many obligations, such as the filing or updating of required forms."[203]

It is important that the adviser, when administering its Compliance Program, avoid making an unreasonably narrow interpretation of the Program's terms or provisions. For example, the SEC has settled an enforcement action against an adviser that had construed the word "error" in its Compliance Program so narrowly that the adviser could avoid disclosing to its ERISA clients a coding error that resulted in the clients holding securities in violation of an issuer-imposed offering restriction.[204] Because of this narrow definition, the SEC believed that the adviser's Compliance Program was not reasonably designed to ensure that errors were promptly corrected and disclosed to affected clients, which was a violation of Rule 206(4)-7.[205]

The identity of the CCO, who must be a natural person, must be disclosed on advisers' Forms ADV and should be an individual with sufficient knowledge of the Advisers Act, "empowered with full responsibility and authority to develop and enforce appropriate policies and procedures . . . and [having] sufficient seniority and authority to compel others to adhere to [them]."[206] The CCO would generally be expected to conduct the required annual review, considering compliance matters that arose during the previous year, changes in business activities and new regulatory developments, and is required to prepare a written report of findings as a result of the review. Form ADV also requires advisers to disclose whether their CCO is compensated or employed by an unrelated person for providing CCO services to the adviser.[207]

In adopting Rule 206(4)-7, the SEC noted that the "failure . . . to have adequate compliance policies and procedures in place will constitute [an independent] violation" of the securities laws, even where no other violation results from the inadequate procedures.[208] Advisers should devote adequate attention and

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[201] *See* Acceptance of Gifts or Entertainment by Fund Advisory Personnel – Section 17(e)(1) of the Investment Company Act, IM Guidance Update No. 2015-01 (Feb. 2015). Although the Guidance Update focused on issues surrounding gifts and entertainment as they pertained to Section 17(e)(1) and Rule 38a-1 under the 1940 Act, the IM staff indicated, in a footnote, that advisers also have a duty to maintain policies and procedures concerning gifts and entertainment pursuant to Rule 206(4)-7. *See id.* at 4 n.8. However, maintaining policies and procedures concerning gifts and entertainment, alone, is not enough, as advisers also have a duty to implement and enforce these policies and procedures. *In re* Guggenheim Partners Inv. Mgmt., LLC, Release No. IA-4163 (Aug. 10, 2015). An adviser could also be found to have made misleading statements in violation of the Advisers Act if it represents in its marketing materials that it does not accept gifts and entertainment, but its gift policy permits the acceptance of gifts. *See In re* Jeffrey Slocum & Associates, Inc., Advisers Act Release No. 4647 (Feb. 8, 2017).

[202] In June 2016, the SEC proposed rules requiring registered advisers to establish business continuity plans (which address business continuity after a significant business disruption) and transition plans (which address business transitions in the event the adviser is unable to continue providing investment advisory services to clients). See Adviser Business Continuity and Transition Plans, 81 Fed. Reg. 43530 (Jun. 28, 2016). The comment period for the rule proposal closed on September 6, 2016. In 2013, OCIE issued a risk alert on investment advisers' business continuity plans, which identifies strengths and weaknesses in advisers' business continuity plans and makes certain suggestions. *See* OCIE, National Exam Program, Risk Alert: SEC Examinations of Business Continuity Plans of Certain Advisers Following Operational Disruptions Caused by Weather-Related Events Last Year (Aug. 27, 2013).

[203] *Id.*

[204] *See* Western Asset Mgmt. Co., Release Nos. IC-30893, IA-3763 (Jan. 27, 2014).

[205] *Id.* at 6–7.

[206] *Id.*

[207] Form ADV and Advisers Act Amendments Adopting Release, *supra*.

[208] *Id.*

resources to the development of a robust compliance system.[209] If SEC examiners warn of deficiencies in an adviser's Compliance Program, then it is important that the adviser act effectively to correct those deficiencies by the next examination period.[210] Through three enforcement actions brought as part of its Compliance Program Initiative, the SEC has shown that it will act aggressively against advisers who have ongoing deficiencies in their compliance program.[211]

7. Pooled Investment Vehicles: Rule 206(4)-8

Rule 206(4)-8 prohibits all advisers, whether registered or unregistered, from making false and misleading statements to, or otherwise engaging in conduct that is fraudulent, deceptive, or manipulative with respect to, investors and prospective investors in certain pooled investment vehicles, including hedge funds, without regard to whether a client or prospective client is involved.[212] Thus, the Rule prohibits false or misleading statements made, for example, to existing investors in account statements as well as to prospective investors in private placement memoranda, offering circulars, or responses to requests for proposals.[213] The Rule applies regardless of whether a pooled investment vehicle is offering, selling, or redeeming securities.

VIII. ETHICS AND MATERIAL NON-PUBLIC INFORMATION

A. Insider Trading and Securities Fraud Enforcement Act ("ITSFEA")

ITSFEA, which added Advisers Act Section 204A in 1988, imposes additional responsibilities and liabilities upon advisers. Section 204A requires advisers to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of material nonpublic information by the adviser or any of its affiliates or employees, including certain independent contractors and consultants.[214] In 2012,

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[209] In June 2015, the SEC settled an enforcement action against an investment adviser, alleging numerous compliance failures, which the SEC attributed to the adviser's underfunding and understaffing of its compliance department. *See In re* Pekin Singer Strauss Asset Mgmt. Inc., Release Nos. IA-4126, IC-31688 (Jun. 23, 2015). In 2014, the SEC settled an enforcement action against Barclays Capital Inc. for numerous securities law violations that arose from the firm's failure to develop an adequate compliance infrastructure to integrate Lehman Brothers Inc. after the September 2008 acquisition. *See* Barclays Capital Inc., Release Nos. 34-73183, IA-3929 (Sep. 23, 2014).

[210] *See* Press Release, SEC, SEC Sanctions Three Firms under Compliance Program Initiative (Oct. 23, 2013). Typical deficiencies or weaknesses identified by OCIE examiners in connection with Rule 206(4)-7 include: compliance manuals are not reasonably tailored to the adviser's business practices; annual reviews are not performed or did not address the adequacy of the adviser's policies and procedures; compliance policies and procedures are not followed; and compliance manuals are not current. OCIE, National Exam Program, Risk Alert: The Five Most Frequent Compliance Topics Identified in OCIE Examinations of Investment Advisers (Feb. 7, 2017).

[211] *See, e.g.*, Modern Portfolio Mgmt. Inc., Release No. IA-3702 (Oct. 23, 2013); Equitas Capital Advisors, LLC, Release Nos. 34- 70743, IA-3704 (Oct. 23, 2013); Stephen Derby Gisclair, Release Nos. 34-70742, IA-3703 (Oct. 23, 2013).

[212] *See* Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, Release No. IA-2628 (Aug. 3, 2007), adopted in response to *Goldstein*, *supra* note 41, which vacated Rule 203(b)(3)-2, the hedge fund adviser registration rule (Release No. IA-2333).

[213] For example, in October 2015, the SEC settled with an investment adviser for its violation of Rule 206(4)-8, as well as other provisions of the federal securities laws, when the adviser shifted its investment strategy for the pooled investment vehicle from a long-credit strategy to a short-credit strategy and failed to disclose this shift to investors and failed to update the corresponding risk factors disclosures. *In re* UBS Willow Mgmt. L.L.C., Release No. IA-4233 (Oct. 16, 2015). Additionally, an adviser was found to have violated Rule 206(4)-8 when it managed a fund in a manner that was inconsistent with the fund's disclosures. *See In re* Riad, Release No. IA-4420 (Jun. 13, 2016).

[214] *See* note 341, below, for a discussion of consultants as insiders.

OCIE published the results of its study of Exchange Act "Chinese Wall" or information barrier procedures implemented by broker-dealers to protect material nonpublic information ("MNPI") which is instructive with respect to identifying barriers which were, or were not, found to be reasonably designed to control misuse of MNPI.[215] As noted in the report, "Section 204A of the Investment Advisers Act of 1940 (the "Advisers Act") places similar obligations on registered investment advisers."[216] For additional information related to insider trading, see the section below entitled "*Rule 10b-5 and Insider Trading*."

The SEC is also authorized to bring a court action against any person who, at the time of the violation, directly or indirectly controlled the person who committed the alleged violation. Under 1934 Act Section 21A(a)(1)(B), which applies to violations of both the 1934 Act and the Advisers Act, the SEC must establish that: (a) the controlling person knew or recklessly disregarded the fact that the controlled person was likely to engage in the act or acts constituting the violation and failed to take appropriate steps to prevent such act or acts from occurring or (b) knowingly or recklessly failed to establish, maintain, or enforce any policy or procedure required under Section 204A, *and* such failure substantially contributed to occurrence of the violation. It should be noted that controlling person liability may attach even where the controlling person is unaware of a particular violation. All that is necessary is some awareness on the part of the controlling person of the controlled person's likelihood to commit a violation, and a knowing or reckless failure by the controlling person to take appropriate steps to prevent violations. Under ITSFEA, investment advisers, and controlling persons generally, who violate this provision face a civil penalty up to $1,000,000 or three times the amount of profit gained or loss avoided by the controlled person's violation.

B. Codes of Ethics: Rule 204A-1

The SEC adopted Rule 204A-1 ("Code of Ethics Rule") under Section 204A which, among other things, regulates personal trading by advisory personnel. When an adviser, its access persons and/or employees trade for their own accounts, conflicts of interest can arise. The SEC has brought a number of enforcement actions against advisers and their employees in this area.[217] These actions indicate that, at a minimum, an adviser must disclose to clients whether it recommends securities to clients in which the adviser or any of its employees also have an interest and make additional disclosure in its Form ADV about its policies and procedures relating to conflicts of interest, including those related to personal trading.[218]

The Code of Ethics Rule requires registered investment advisers to adopt Codes that, at minimum: (a) set forth standards of business conduct reflecting the fiduciary obligations applicable to the adviser and its "supervised persons" as defined in the Act; (b) include provisions requiring an adviser's supervised persons to comply with applicable federal securities laws; (c) require "access persons" of the adviser to report, and

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[215] *See* OCIE's Staff Summary Report on Examinations of Information Barriers: Broker-Dealer Practices under Section 15(G) of the Securities Exchange Act of 1934 (Sep. 27, 2012) [hereinafter Barriers Report].

[216] *Id.* at 5.

[217] *See In re* Federated Global Investment Management Corp., Release No. IA-4401 (May 27, 2016) (SEC enforcement action against an adviser for, among other things, the adviser's failure to have policies and procedures in its code of ethics that enabled the compliance department to identify whether certain outside consultants should be considered access persons); Consulting Services Grp., LLC, Release Nos. 34-56612, IA-2669 (Oct. 4, 2007); Strong Capital Mgmt., Inc., Release Nos. 34-49741, IC-26448, IA-2239 (May 20, 2004); Putnam Investment Mgmt. LLC, Release No. IA-2192 (Nov. 13, 2003); Alliance Capital Mgmt., L.P., Release No. IA-1630 (Apr. 28, 1997); Janus Capital Corp., Release Nos. 34-38161, IC-22461, IA-1605 (Jan. 13, 1997); Roger W. Honour, Release No. IA-1527 (Sep. 29, 1995).

[218] Rule 204-2(a)(12).

the adviser to review, their personal securities transactions[219] and holdings periodically and obtain approval before investing in any initial public offering or limited offering; (d) require prompt reporting, to the CCO or another designated person, of any Code violations; and (e) require the adviser to provide each supervised person with a copy of the Code and any amendments, and require each recipient to acknowledge, in writing, receipt of the Code.[220]

In 1994, the ICI issued a number of recommendations regarding personal trading by mutual fund and investment adviser personnel, which offer advisers guidance as to procedures that can be implemented to help avoid conflicts of interest. Some of the recommendation include: (a) pre-clearing personal trades; (b) "black-out periods" both before and after clients trades during which employees are prohibited from trading for their own accounts; (c) holding periods or profit-bans during which employees cannot profit from personal trades; (d) prohibition against personal trades in IPOs; (e) special procedures for personal trades in privately placed securities; and (f) annual certification of personal holdings and compliance with the firm's Code.[221]

Many advisers looked to the ICI recommendations in drafting their Codes.[222] Rule 204A-1 provides a limited exemption from certain provisions of the Code of Ethics Rule for advisers whose sole employee is the adviser himself. Each registered adviser is required to describe its Code in Form ADV Part 2A and to state that the Code is available upon request.

IX. INVESTMENT ADVISORY CONTRACTS

Advisers Act Section 205 provides that no adviser registered or required to be registered may enter into, extend, or renew any advisory contract that contains certain prohibited provisions or that omits certain other material provisions. Investment advisory contracts are restricted by the Advisers Act in the following manner:

A. Performance Fees: Subsection 205(a)(1) and Rule 205-3

Except under limited circumstances, no advisory contract may provide for compensation to be paid to the adviser on the basis of a share of capital gains or appreciation of any portion of the client's funds, otherwise known as a "performance fee," which means an advisory fee that varies with the adviser's success in managing client money. Congress prohibited performance fees based on a concern that performance fees could result in undue speculation with clients' investments by encouraging advisers to seek maximum personal gain through taking maximum risks with client assets. Any fee contingent upon some level of

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[219] *But see* M&G Investment Mgmt. Ltd., SEC No-Action Letter (Mar. 1, 2007) (granting relief to a U.K.-based adviser to permit Access Persons not performing services for M&G's lone U.S.-registered investment company client not to report securities transactions in securities which had no existing secondary market).

[220] Investment Adviser Codes of Ethics, Release Nos. IC-26492, IA-2256 (Jul. 2, 2004) (final rule). The SEC also adopted certain related record-keeping requirements and conforming amendments to Company Act Rule 17j-1. In 2017, OCIE issued a risk alert stating that typical weaknesses or deficiencies identified by OCIE examination staff relating to advisers' compliance with Rule 204A-1 included: failure to identify access persons; required information missing in code of ethics; untimely submission of transactions and holdings; and no description of the code of ethics in Forms ADV, OCIE, National Exam Program, Risk Alert: The Five Most Frequent Compliance Topics Identified in OCIE Examinations of Investment Advisers (Feb. 7, 2017).

[221] *See* Company Act Rule 17j-1 for related requirements.

[222] After the adoption of the Code of Ethics Rule, the Investment Counsel Association of America (now the IAA) also issued a Code of Ethics drafting guide. *See* "ICAA Issues Best Practices for Investment Adviser Codes of Ethics" (Jul. 20, 2004), available to IAA members only on the IAA website.

investment performance would generally be considered a performance fee and thus unlawful.[223] A fee based on a percentage of premium income received for writing options also is a performance fee.[224]

This general prohibition, however, does not prohibit an investment advisory contract which provides for compensation based upon the total value of a fund averaged over a definite period, or as of definite dates, or taken as of a definite date.[225] Moreover, this prohibition does not apply to an investment advisory contract with certain "big players", including: (a) a registered investment company or (b) any other person (except a trust, governmental plan, collective trust fund, or separate account), provided the contract relates to the investment of assets in excess of $1 million, *if* the contract provides for compensation based on the asset value of the company or fund under management averaged over a specified period and increasing or decreasing proportionately the investment performance of the company or fund over a "specified period" in relation to the "investment performance" of an "appropriate index of securities prices" or such other measure of investment performance as the SEC may specify, also known as a "fulcrum fee."[226] The Staff refused to grant no-action relief in a situation where the fulcrum fee could increase to a greater extent than it could decrease,[227] but granted no-action relief where a fulcrum fee decreased more rapidly than it increased.[228] Performance fees are also permitted for certain advisory contracts with business development companies, qualified purchaser private investment companies, and foreign persons.[229]

Advisers Act Rule 205-3 permits investment advisers to charge performance-based fees to "qualified clients."[230] In order to fall within that definition, clients must have at least $1,100,000 under the management of the adviser (or certain other affiliated advisers conducting a single advisory business)[231] or have a net worth over $2.2 million.[232] A qualified client's net worth must exclude net equity in a primary residence,[233] have a 60-day look back period, and be calculated only once, at the time of entering into the advisory

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[223] *See* Release No. IA-721 (May 16, 1980).

[224] *See* Oppenheimer Capital Corp., SEC No-Action Letter (Apr. 18, 1985); Roman S. Gorski, Release No. IA-214 (Dec. 22, 1967).

[225] Section 205(b)(1).

[226] Section 205(b)(2). *See also* Rules 205-1 and 205-2 for definitions of terms relating to fulcrum fees. Despite the statutory language of Section 205(b)(2), the staff has not objected to fee arrangements that provide greater penalties for sub-par performance than rewards for better performance.

[227] *See* Lowry, Bittel, Perrot & Co. Fund Advisers, Inc., SEC No-Action Letter (Jul, 3, 1986).

[228] *See* Royce Value Trust, Inc., SEC No-Action Letter (Dec. 22, 1986).

[229] Section 205(b)(3) – (5).

[230] The "qualified client" distinction allows investment advisers to charge performance-based fees to certain clients. Rule 205-3 sets financial thresholds that must be met for a client to be considered "qualified," which may be adjusted by the SEC. See 17 CFR § 275.205-3(d)(1).

[231] Status of Certain Private Fund Investors as Qualified Clients, IM Guidance Update No. 2013-10 (Nov. 2013), (allowing advisers that are registered jointly as a single advisory business, in reliance on the SEC's January 18, 2012, no-action letter to the American Bar Association, to aggregate the client's investments in all of the private funds advised by that single advisory business, so as to determine whether the client has $1,000,000 under management).

[232] In 2016, the SEC revised the net worth threshold from $2 million to $2.1 million. *See* Order Approving Adjustment for Inflation of the Dollar Amount Tests in Rule 205-3 under the Investment Advisers Act of 1940, Release No. IA-4421 (Jun. 14, 2016).

[233] The primary residence exclusion was not mandated for qualified clients by Dodd-Frank, but the SEC decided to harmonize the qualified client net worth test with the mandatory changes to the Regulation D "accredited investor" net worth test set forth in Section 413(a) of Dodd-Frank. *See* Investment Adviser Performance Compensation, Release No. IA-3372, at 8 n.33.

contract. As required by the Dodd-Frank Act, Subsection 205-3(e) requires the SEC to issue an order every five years adjusting for inflation the dollar amount thresholds of the client AUM and net worth tests.

The term "qualified client" also includes any "qualified purchaser" as defined by Company Act Section 2(a)(51)(A) and certain "knowledgeable employees" of the adviser. "Knowledgeable employees" typically include executive officers, directors, and high-level employees of a fund or an affiliated management person. This can also include employees who actively participate in the fund's investment activities for at least 12 months. The rationale being that such "knowledgeable employees" are sophisticated enough to make investment decisions.[234] Grandfathering provisions exist for fund investors whose investments were lawful prior to the amendment of the rule or prior to the adviser becoming subject to the rule.

The Staff takes the position that Section 205's restrictions on performance-based fees further prohibits an adviser from being a party to any advisory contract which provides that fees will be waived or refunded, in whole or in part, if a client's account does not meet a specified level of performance or which otherwise makes receipt of advisory fees contingent on the investment performance of advisory clients. The staff considers any "contingent" fee arrangement to be tantamount to a fee dependent on a client's account achieving a specified level of capital gains or appreciation, and thus prohibited by Section 205(a)(2).

B. No Assignment Without Permission

All advisory contracts must contain terms to the effect that no assignment of the contract may be made by the adviser without client consent.[235] "Assignment" of a contract is defined in the Advisers Act to include any indirect transfer or hypothecation of an investment advisory contract, or any transfer of a "controlling" block of the assignor's outstanding voting securities.[236] "Control" means the power to exercise a controlling influence over the management or policies of the adviser, unless the power is solely the result of an official position with the adviser (e.g., a portfolio manager who has no ownership interest in the firm). Ownership of 25% or more of an adviser's outstanding voting securities is generally presumed to be a controlling position.

C. Disclosure of Partnership Changes

For an investment adviser organized as a partnership, Section 205(a)(3) requires the advisory contract to include a provision requiring the adviser to notify the client of any change in the membership of the partnership within a reasonable time after such change.

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[234] *See* SEC, Amendments to Accredited Investor Definition (Aug. 26, 2020).

[235] Section 205(a)(2). Note that the client consent is not required to be written, leaving room for the use of "negative" consent. *See* Jennison Assocs. Capital Corp., SEC No-Action Letter (Dec. 2, 1985).

[236] Section 202(a)(1).

X. OTHER SUBSTANTIVE PROVISIONS

A. Duty of Supervision

Registered investment advisers have a continuing responsibility to comply with the Advisers Act, and this duty includes the supervision of and responsibility for anyone acting on their behalf.[237] This duty to supervise is comparable to the duty to supervise imposed upon broker-dealers under the 1934 Act.

B. Hedge Clauses

Historically, Advisers Act Section 215 has been interpreted to void "hedge clauses" appearing in advisory contracts.[238] A hedge clause is a statement or legend which could cause an investor to believe that legal rights are given up and a remedy is foreclosed which might otherwise have been available under statutory or common law.

At least since 2007, if not before, advisers have sought contractual ways to limit liability, primarily by including indemnification and exculpation hedge clause provisions. In 2007, the SEC staff issued (but later rescinded) a no-action letter to Heitman Capital Management, LLC, confirming that whether such a hedge clause would violate an adviser's fiduciary duty would depend on all the facts and consideration of the form and content in which the hedge clause was made. In the context of a retail client, the staff no-action letter described three factors to consider:

- whether the hedge clause was written in plain English;
- whether the hedge clause was highlighted and explained in person; and
- whether the hedge clause disclosure explained when a client might still have a right of action notwithstanding language in the clause conveying the contrary. To this extent, and to the extent that hedge clauses were included in contracts with institutions and sophisticated intermediaries (e.g., wrap-fee program sponsors), the staff concluded that, while dependent on the facts, such clauses would not constitute a per se violation of Sections 206(1) and (2) of the Advisers Act.

In the Fiduciary Interpretation (from 2019), the SEC withdrew the Heitman no-action letter, noting that some commenters suggested some have misapplied the staff's position in that letter. In doing so, the SEC took the occasion to state that "an adviser's federal fiduciary duty may not be waived, though its application may be shaped by agreement." It reaffirmed the general position that a determination that a hedge clause raises a potential violation of the Advisers Act fiduciary duty is a fact-intensive evaluation (including evaluation of the client's particular circumstances and sophistication). The SEC made clear that a contract provision purporting to waive the adviser's federal fiduciary duty generally—such as (i) a statement that the adviser will not act as a fiduciary, (ii) a blanket waiver of all conflicts of interest, or (iii) a waiver of any specific obligation under the Advisers Act—would be inconsistent with the Advisers Act, regardless of the sophistication of the client. Leaving the factual nature of this analysis in the context of an institutional client alone, the SEC in the Fiduciary Interpretation made abundantly clear:

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[237] *See* Section 203(e)(6). *See also* Justin Federman Stone, 41 S.E.C. 717 (1963); TBA Financial Corp., SEC No-Action Letter (Dec. 7, 1983).

[238] *See* Interpretive Release No. IA-58 (Apr. 10, 1951).

> In our view, however, there are few (if any) circumstances in which a hedge clause in an agreement with a retail client would be consistent with those antifraud provisions, where the hedge clause purports to relieve the adviser from liability for conduct as to which the client has a non-waivable cause of action against the adviser provided by state or federal laws. Such a hedge clause generally is likely to mislead those retail clients into not exercising their legal rights, in violation of the antifraud provisions, even where the agreement otherwise specifies that the client may continue to retain its non-waivable rights.

The SEC did not define the terms "retail client" or "institutional client" and did not indicate how advisers to pooled investment vehicles should apply the above principles.

Since then, the SEC has brought enforcement actions against investment advisers for their use of hedge clauses in certain contexts, particularly if the advisory agreement involved "retail" clients or investors. For example, the *In re Global Predications, Inc*. (March 2024), an investment adviser included liability disclaimer language (a "hedge clause"), in its advisory contract with retail clients, purporting to relieve it from liability for "any claim or demand," as well as requiring clients to indemnify and hold harmless from any third-party claim or demand arising out of the use of the investment adviser's services. The investment adviser also claimed in the agreement that it did "not give financial or investment advice or advocate the purchase or sale of any security or investment," despite saying the opposite in its form ADV.

Similarly in *In re ClearPath Capital Partners, LLC* (Sep. 2024), several violations were found, including, notably, the investment adviser's use of misleading hedge clauses in its advisory agreements, partnership agreements, and operating agreements for hedge funds that had "retail" investors. The investment adviser used hedge clauses that purported to broadly limit liability and the scope of the investment adviser's unwaivable fiduciary duty.[239]

Fund sponsors should take care when drafting and including hedge clauses in fund offering documents if there is risk that the fund might admit a non-institutional investor or a less sophisticated investors.

C. Effect of SEC Registration

An investment adviser may state that it is SEC registered, but must not imply that SEC registration indicates sponsorship, recommendation, approval, or acknowledgment of the adviser's ability by the SEC or by any U.S. Government agency or official.[240]

D. Use of the Term "Investment Counsel"

The term "investment counsel" (unless used accurately to describe the title of registration in certain states) may not be used to describe an adviser unless his principal business is acting as an investment adviser and a substantial part of that business consists of rendering "investment supervisory services."[241]

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[239] *See In re* Global Predications, Inc., Release No. 6574 (Mar. 18, 2024),; *see also*, *In re ClearPath Capital Partners, LLC* Release No. 6672 (Sep. 3, 2024).

[240] Section 208(a).

[241] Section 208(c).

XI. DISCLOSURE AND RECORDKEEPING REQUIREMENTS

A. "Brochure Rule"

Pursuant to Rule 204-3, registered investment advisers must furnish each present and prospective advisory client with a copy of the Form ADV Part 2A "Brochure," a narrative written disclosure document. Delivery of the Brochure must be made no later than at the time of entering into any advisory contract (either written or oral) with any current or prospective advisory client.[242] A Brochure need not be offered or delivered in connection with entering into either an advisory contract with a registered investment company or any contract for impersonal advisory services.[243]

A registered investment adviser must, in addition, annually deliver free of charge a copy of its current Brochure or summary of materials changes to the Brochure to all clients, except for registered investment company clients, clients for whom the adviser provides impersonal advisory services requiring payment of less than $500; certain other clients not required to receive Brochures; and employees or related persons who satisfy the definition of "qualified client" under the performance fee rule.[244] Delivery of the brochure must be made to the client within 120 days after the end of the adviser's fiscal year.[245] In addition, advisers must deliver to certain clients the Part 2B Brochure Supplement describing certain advisory personnel as required.[246] Material changes to the Brochure or Brochure Supplements must be delivered to all applicable clients and prospective clients *promptly*.[247] The SEC has emphasized the importance of adequate disclosure of conflicts of interest in the Form ADV Part 2A. For example, in a 2014 enforcement action, the SEC alleged that the adviser had violated the antifraud provisions by making inadequate disclosures in its Form ADV Part 2A when the adviser stated, among other things, that it "*may* receive compensation" from a broker-dealer, which misrepresented the fact that the adviser *was* receiving compensation from the broker-dealer.[248]

Special disclosure requirements apply to advisers to wrap fee programs. They must furnish a special wrap program version of the Brochure to prospective wrap fee clients and at least annually to existing wrap fee clients.[249] The information disclosed in a wrap fee brochure is provided to wrap fee clients in lieu of Part 2A of Form ADV. The adviser must promptly update its wrap fee program brochure to reflect material changes, and must update the wrap fee brochure within 90 days after the end of a sponsor's fiscal year end to reflect other changes.[250]

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[242] Rule 204-3(b)(1). Many states still require delivery 48 hours in advance or clients have a five day period to rescind the contract without penalty. This is no longer required for federally registered advisers.

[243] Rule 204-3(b)(1). Under Rule 204-3(h)(1), "impersonal advisory services" means advice not purporting to be tailored to the specific needs of a particular client and/or statistical reports, which do not provide advice as to any particular security.

[244] Rule 204-3(c).

[245] Rule 204-3(b)(2).

[246] Rule 204-3(b)(3).

[247] Rule 204-3(b)(4).

[248] Robare Grp., Ltd., Release Nos. 34-72950, IC-31237, IA-3907 (Sep. 2, 2014).

[249] Rule 204-3(d); Form ADV Part 2A Appendix 1.

[250] Effective October 1, 2017, advisers are also required to include additional information in their Form ADV Part 1 filing if they participate in wrap fee programs. *See* Form ADV and Advisers Act Amendments Adopting Release, *supra*.

In addition to brochure disclosure, advisers may also have contractual disclosure obligations under the general antifraud provision. For example, in a 1990 enforcement action, the SEC found that an adviser's failure to disclose in an advisory contract the fees received by the adviser for managing a money market fund into which excess cash was swept, and the adviser's inadequate disclosure of "float" benefits to the investment adviser's affiliated broker-dealer, violated the Act's antifraud provisions.[251]

B. Recordkeeping Requirements

Advisers Act Section 204 requires investment advisers registered or required to be registered to keep such records as the SEC shall require. These records are subject to SEC inspection at any time.

Rule 204-2 contains an extensive list of the records that advisers are required to keep. Generally, advisers must preserve these records for at least five years from the end of the fiscal year during which the last record entry was made.[252] Records relating to the most recent two years must be kept at the office of the adviser; records for the remaining period may be kept in any "easily accessible place," and may be preserved on microfilm or stored in electronic form provided they are safeguarded, easily accessible, and reproducible.[253] All organizational and governing documents of the adviser (corporate articles, partnership agreements, by-laws, etc.) must be kept at the adviser's principal place of business until three years after the termination of the adviser's enterprise.[254]

Any record made and kept pursuant to 1934 Act Rules 17a-3 and 17a-4 (relating to records requirements for brokers and dealers) which are substantially the same as any records required under the Advisers Act may be used to satisfy the adviser's record-keeping requirements. Moreover, no requirement contained in the list of required books and records requires the creation of any duplicate record (i.e., individual records may serve more than one function).

All registered investment advisers must keep true, "current"[255] and accurate books and records as follows (in all cases, the client's identity may be designated by number or other code):[256]

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[251] Thomson McKinnon Mgmt. L.P., Release No. IA-1243 (Jul. 26, 1990).

[252] A significant exception to this general rule is found in Rule 204-2(e)(3), which requires books and records necessary to form the basis for or demonstrate the calculation of performance to be maintained for a period of not less than five *years from the end of the fiscal year during which the adviser last published the figures.*

[253] Rule 204-2(e)(1) (setting time frame for retaining books and records); Rule 204-2(g) (permitting micrographic and electronic storage provided certain requirements are satisfied).

[254] Rule 204-2(e)(2).

[255] For primary records of transactions (such as invoices, logs, confirmations, certain journals, and order memoranda), "current" means created concurrently with the transaction or shortly thereafter. Secondary records (such as ledgers or other records to which transactional data are posted) need not be updated as transactions occur. Actual frequency of posting to keep records current will depend on the circumstances of the individual advisory business.

[256] Section 210(c) provides that no reporting requirement under the Advisers Act may be construed to require an adviser to disclose to the SEC the identity, investments, or affairs of a client unless this information may relate to a particular proceeding or investigation brought to enforce a provision or provisions of the Act.

- Journal(s), including cash receipts and disbursements records, and any other records of original entry forming the basis of entries in any ledger.[257]

- General and auxiliary ledgers (or comparable records) reflecting asset, liability, reserve, capital, income, and expense accounts.

- A memorandum[258] of each order given by the adviser or of instructions received by the adviser to purchase or sell any security, showing: (a) the terms and conditions of the order; (b) any modification or cancellation of the order; (c) the identity of the person who recommended the transaction to the client and of the person who placed the order; (d) the account for which the adviser was entered and the date of entry; (e) the identity of the bank, broker, or dealer by or through whom the order was executed (where appropriate); and (f) designation of orders entered pursuant to use of a discretionary power.

- All check books, bank statements, canceled checks, and cash reconciliations of the firm.

- All bills or statements, paid or unpaid, relating to the business of the adviser as such.

- All trial balances, financial statements, and internal audit working papers.

- Originals of all written communications received and copies of all written communications sent relating to: (a) recommendations or advice given or proposed to be given (see Important Note below); (b) any receipt, disbursement, or delivery of funds or securities; (c) the placing or execution of any purchase or sell order; (d) "predecessor performance" (as defined in the Marketing Rule) and the performance or rate of return of any or all managed accounts, "portfolios" (as defined in the Marketing Rule); or (e) securities recommendations.[259] However, with respect to (d) above, advisers need not keep unsolicited market letters and similar communications of general public distribution not prepared by or for the adviser. Also with respect to (d) above, if notices, circulars, or any other "advertisement" (as defined in the Marketing Rule) offering any report, analysis, publication, or other investment advisory service are sent to more than 10 persons, the adviser is not required to keep a list of all addresses to which these communications were sent. Nevertheless, the adviser must keep a copy of the communication and a description of the address list and its source.

  ***IMPORTANT NOTE*:** "Communications" for this purpose includes all manner of electronic communications, e.g., texts, emails, tweets, and other forms of communication on social media

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[257] For example of a failure of an investment adviser to properly maintain records, see *In re* Aon Investments USA Inc., fka Aon Hewitt Investment Consulting, Inc. (Jan. 2024) and the related *In re* Claire P. Shaughnessy (Jan. 2024). Here, the adviser failed to adequately investigate a discrepancy between the underlying performance data used by the adviser to calculate the "risk share return rate" and the historically reported returns—despite the investor pointing out the discrepancy. See also In re Jordan/Zalaznick Advisers, Inc. (Sep. 20, 2024) (discussing a failure to audit internal books and records, despite that requirement being contained in the fund's governing documents and policies).

[258] If an adviser uses an order ticket to satisfy this requirement, as is common, the order ticket must include all of the required items.

[259] The Staff has granted a third party recordkeeper no-action relief to allow all advisers subscribing to its services to rely on its electronic recordkeeping of trade confirmations for purposes of Rule 204-2, subsections (a)(7), (b)(3) and (g), without downloading, printing, or keeping their own copies based on the third party's representations that it would make records available to adviser customers, including former customers, within 24 hours, maintain such records for at least five years after the last entry, and make arrangements to ensure the continued availability of records in the event that it ceases operations. *See* Omgeo LLC, SEC No-Action Letter (Aug. 14, 2009).

platforms/channels, chats, instant messages, and the like. The requirement described in (a) above, i.e., communications regarding advice given, has been at the heart of ongoing enforcement activity against registrants for recordkeeping violations related to "off-channel" communications.[260]

- A list (or record) of all discretionary accounts.[261]

- Powers of attorney, and other documentation evidencing discretionary powers.

- All written agreements with clients (and others relating to firm business).

- Copies of each "advertisement" (as defined in the Marketing Rule) that the adviser disseminates (directly or indirectly), except that: (a) for oral advertisements, the adviser may instead retain a copy of any written or recorded materials used by the adviser in connection with the oral advertisement and (b) for compensated oral testimonials and endorsements (as those terms are defined in the Marketing Rule), the adviser may instead make and keep a record of the disclosures provided to clients or investors pursuant to that rule. See also Important Note below.

- Copies of any notice, circular, newspaper article, investment letter, bulletin, or other communication that the adviser disseminates, directly or indirectly, to ten or more persons (other than persons associated with the investment adviser). See also ***Important Note*** below.

***IMPORTANT NOTE*:** If a communication described in either of the above two bullets recommends the purchase or sale of a specific security and the communication does not state the reasons for the recommendation, the adviser must have a background memorandum stating those reasons.

- Copies of any questionnaire or survey used in the preparation of a third-party rating included or appearing in any advertisement in the event the adviser obtains a copy of the questionnaire or survey.

- A record of the disclosures provided to clients or investors pursuant to the Marketing Rule's requirements for testimonials and endorsements, if such disclosures are not included within the advertisement itself.

- Documentation substantiating the adviser's reasonable basis for believing that a testimonial or endorsement complies with the Marketing Rule and that any third-party rating complies with requirement under the Marketing Rule regarding unbiased surveys/questionnaires.

- A record of the names of all persons who are an investment adviser's partners, officers, directors, or employees, or a person that controls, is controlled by, or is under common control with the

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[260] *See* Mayer Brown Legal Update, WhatsApp All Over Again: the SEC Brings More Recordkeeping Charges Against Broker Dealers and Investment Advisers for Off-Channel Communications (Feb. 13, 2024). *See* related SEC releases: *In re* Retirement Investment Advisors, Inc., Release Nos. 34-76218, IA-4237 (Oct. 21, 2015), (involving emails between the adviser and its clients, even though the emails were from a personal email account and were primarily personal); *In re* Atom Investors LP, Release No. 6719 (Sep. 23, 2024); *In re* Qatalyst Partners LP, Release No. 101143 (Sep. 24, 2024); *See also*, *supra* footnote 177.

[261] In the Staff's view, four "attributes of discretion" must be present: (1) the ability to select the security to be purchased or sold; (2) the ability to determine the amount of the security (either number of shares or principal amount); (3) the ability to select the time a transaction will take place; and (4) the ability to determine the unit price that is to be paid or received.

investment adviser, or is a partner, officer, director, or employee of such a person pursuant to the Marketing Rule's exceptions from certain testimonial/endorsement requirements for affiliates.

- A record of who the "intended audience" is pursuant to the Marketing Rule's hypothetical performance requirements.

- All accounts, books, internal working papers, and any other records or documents necessary to form the basis for or demonstrate the calculation of the performance or rate of return of any or all managed accounts, "portfolios" (as defined in the Marketing Rule) or securities recommendations in any notice, circular, "advertisement," newspaper article, investment letter, bulletin, or other communication that the adviser disseminates, directly or indirectly, to *any* person (other than persons associated with the adviser),[262] including copies of all information provided or offered pursuant to the Marketing Rule's hypothetical performance requirements. With respect to the performance of managed accounts, the retention of all account statements, if they reflect all debits, credits, and other transactions in a client's or investor's account for the period of the statement, and all worksheets necessary to demonstrate the calculation of the performance or rate of return of all managed accounts is deemed to satisfy these requirements.

- A copy of each brochure, brochure supplement and Form CRS, and each amendment or revision to the brochure, brochure supplement, and Form CRS, that satisfies the requirements of Part 2 or Part 3 of Form ADV, as applicable; any summary of material changes that satisfies the requirements of Part 2 of Form ADV but is not contained in the brochure; and a record of the dates that each brochure, brochure supplement and Form CRS, each amendment or revision, and each summary of material changes not contained in a brochure given to any client or to any prospective client who subsequently becomes a client.

- A memorandum describing any legal or disciplinary event listed in Item 9 of Part 2A or Item 3 of Part 2B (Disciplinary Information) and presumed to be material, if the event involved the investment adviser or any of its supervised persons and is not disclosed in the brochure or brochure supplement described above. The memorandum must explain the investment adviser's determination that the presumption of materiality is overcome, and must discuss the factors described in Item 9 of Part 2A of Form ADV or Item 3 of Part 2B of Form ADV.

- Documentation describing the method used to compute managed assets for purposes of Item 4.E of Part 2A of Form ADV, if the method differs from the method used to compute regulatory assets under management in Item 5.F of Part 1A of Form ADV.

Additional records that are maintained by advisers with "custody" of client funds or securities include:[263]

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[262] The Staff has provided guidance on maintaining records relating to performance calculations. *See, e.g.,* Salomon Brothers Asset Mgmt. Inc., SEC No-Action Letter (Jul. 23, 1999) (permitting record-keeping methods in lieu of retention of the adviser's documents of original entry); *see also* Jennison Assocs. LLC, SEC No-Action Letter (Jul. 6, 2000) (declining to provide no-action assurance that particular records are sufficient under Rule 204-2(a)(16)).

[263] Rule 204-2(b). An investment adviser is deemed to have custody if it directly or indirectly holds client funds or securities, has any authority to obtain possession of them, or has the ability appropriate them. Actual possession of client funds or securities is not necessary for an investment adviser to be deemed to have custody of client assets - access and control are sufficient.

- Journal (or other record) showing all purchases, sales, receipts, and deliveries of securities (including certificate number), and all debits and credits.

- Separate ledger account for each client showing: purchases, sales, receipts, and deliveries of securities, date, and price of each purchase or sale, and all debits and credits.

- Copies of confirmations of all transactions effected by or for the account of any such client.[264]

- Record for each security in which any such client has a position, showing the name of client, amount or interest of client, and location of each security.

- A memorandum describing the basis upon which the adviser has determined that the presumption that any related person is not operationally independent has been overcome.

- A copy of any internal control report obtained or received under the Custody Rule, if required.

Records required for advisers rendering investment supervisory or management services include:[265]

- Records showing separately for each client, the securities purchased and sold, and the date, amount, and price of each purchase or sale.

- For each security in which any client has a current position, the adviser should be able to furnish "promptly"[266] information as to the name of the client and the current amount or interest of such client.

Records required for advisers that vote proxies on behalf of their clients:

- Copies of all proxy voting policies and procedures.

- A copy of each proxy voting statement received regarding client securities.[267]

- A record of each vote cast on behalf of a client.[268]

- A copy of any document created by the investment adviser that was material to making a decision on how to vote proxies for a client or that memorializes the basis of that decision.

- A copy of each written client request for voting information and copy of any written response to a client request (either written or oral).

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[264] See *supra* note 259 (referencing Staff no-action relief granted to Omgeo LLC, a third-party recordkeeping service under, among other provisions, Rule 204-2(b)(3)).

[265] Rule 204-2(c). The Advisers Act defines "investment supervisory services" to mean the giving of continuous advice as to the investment of funds on the basis of the individual needs of each client. Section 202(a)(13).

[266] "Promptly," as used under this Rule, generally means within 24 hours.

[267] Advisers may rely on EDGAR or third-party records to satisfy this requirement if the adviser has obtained the third party's undertaking to promptly provide copies upon request.

[268] Advisers may also rely on third-party records to satisfy this requirement.

Records relating to the Compliance Rule:

- Copies of all compliance policies and procedures in effect at any time during the previous five years.
- Documentation of each annual review of these policies and procedures for the previous five years.

Records relating to the Code of Ethics Rule:

- A copy of the investment adviser's code of ethics that is in effect, or at any time in the past five years was in effect.
- A record of any violation of the code of ethics and of any action taken as a result of the violation.
- A record of all written acknowledgments as required by the Code of Ethics Rule, for each person who is currently, or within the past five years was, a supervised person of the investment adviser.
- A record of each report made by an "access person"[269] which includes: [270]

  Holdings Reports for every "reportable security"[271] held by the access person. Holding Reports, which must be submitted within 10 days after becoming an access person and not less frequently than annually thereafter on a date selected by the adviser, must contain information, current as of a date not more than 45 days prior to the date the report was submitted, as to (a) the title and type of security, and as applicable the exchange ticker symbol or CUSIP number, number of shares, and principal amount of each reportable security in which the access person has any direct or indirect "beneficial ownership";[272] (b) the name of any broker, dealer, or bank with which the access person maintains an account in which any securities are held for the access person's direct or indirect benefit; and (c) the date the access person submits the report.

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[269] An access person is any of an adviser's supervised persons who (1) has access to non-public information regarding any client's purchase or sale of securities, or non-public information regarding the portfolio holdings of any reportable fund or (2) is involved in making securities recommendations to clients or has access to such recommendations that are non-public. An adviser whose primary business is providing investment advice must presume that all of its directors, officers, and partners are access persons. Rule 204A-1(e)(1) . Company Act Section 17(j) and related Rule 17j-1 impose additional requirements on "access persons" as defined in Rule 17j-1, which generally includes the same persons that are "access persons" under Rule 204A-1(e)(1) as well as certain other persons associated with the investment company and its principal underwriter (e.g., fund directors or trustees).

[270] The adviser or IAR also may include a disclaimer to the effect that reporting of a transaction is not an admission that such beneficial interest exists.

[271] A reportable security under the Advisers Act is any "security" as defined under the Act, except for: (1) direct obligations of the U.S. government, (2) banker's acceptances, bank certificates of deposit, commercial paper, and high quality short-term debt instruments, including repurchase agreements, (3) shares issued by money market funds (including affiliated funds), (4) shares issued by open-end funds other than "reportable funds", and (5) shares issued by unit investment trusts ("UITs") that are invested exclusively in one or more open-end funds, none of which are reportable funds. A "reportable fund" is any fund managed or advised by the investment adviser or any fund whose investment adviser or principal underwriter controls, is controlled by or is under common control with the investment adviser. The Staff declined to provide no-action assurance that exchange-traded funds organized as UITs are not reportable funds. *See* National Compliance Service, SEC No-Action Letter (Nov. 30, 2005).

[272] Generally, a person has a beneficial ownership in a security if he or she, directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise, has or shares a direct or indirect pecuniary interest in the security. There is a presumption of a pecuniary interest in a security held or acquired by a member of a person's immediate family sharing the same household.

Transaction Reports for each transaction *involving* a reportable security in which the access person had, or as a result of the transaction acquired any direct or indirect beneficial ownership. Transaction reports, to be made not later than 30 days after the end of each calendar quarter, must include: (a) the date of the transaction, the title, and as applicable the exchange ticker symbol or CUSIP number, interest rate, and maturity date the title and amount of the security involved; (b) the nature of the transaction (i.e., purchase, sale, or any other type of acquisition or disposition); (c) the price of the security at which the transaction was effected; (d) the name of the broker, dealer, or bank through which the transaction was effected; and (e) the date the access person submits the report.

The following reports are not required to be submitted: (a) reports with respect to securities held in accounts over which the access person had no direct or indirect influence or control;[273] (b) transaction reports with respect to transactions effected pursuant to an "automatic investment plan"; or (c) reports which would duplicate information contained in broker trade confirmations or account statements held in the adviser's records and received prior to the time when the applicable report would have been due.

- A record of the names of persons who are currently, or within the past five years were, access persons of the investment adviser.

- A record of any decision, and the reasons supporting the decision, to approve the acquisition of securities by access persons under the code for at least five years after the end of the fiscal year in which the approval is granted.

Records relating to the Pay-to-Play Rule:

- The names, titles, and business and residence addresses of all covered associates.

- All government entities to which adviser provides or has provided investment advisory services, or which are or were investors in any covered investment pool to which adviser provides or has provided investment advisory services, in the past five years, but not prior to September 13, 2010. All direct or indirect contributions made by adviser or any of its covered associates to an official of a government entity, or direct or indirect payments to a political party of a State or political subdivision thereof, or to a political action committee. These records must be listed in chronological order and indicate: (A) The name and title of each contributor; (B) The name and title (including any city/county/State or other political subdivision) of each recipient of a contribution or payment; (C) The amount and date of each contribution or payment; and (D) Whether any such contribution was the subject of the exception for certain returned contributions pursuant to the Pay-to-Play Rule.

- The name and business address of each regulated person to whom adviser provides or agrees to provide, directly or indirectly, payment to solicit a government entity to provide investment advisory services.

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[273] In guidance, the IM Division has clarified that the "no direct or indirect influence or control" reporting exception would be available when: (1) the access person has delegated discretionary authority over his or her personal account or trust to a third-party trustee or manager and (2) the investment adviser has adopted policies and procedures that are reasonably designed to determine whether the access person actually has direct or indirect influence or control over the trust or account. IM Guidance Update 2015-03 (Jun. 2015).

***IMPORTANT NOTE*:** An investment adviser is only required to make and keep current the records referred to in the first and third bullets above if it provides investment advisory services to a government entity or a government entity is an investor in any covered investment pool to which the investment adviser provides investment advisory services.

XII. REGULATORY OVERSIGHT

Inspections are usually conducted by personnel in the Commission's various Regional Offices, although personnel from the SEC's Division of Examinations may accompany regional examiners and may intervene to resolve issues raised by registrants with respect to examiners' requests. There are currently seven general categories of inspections:

A. Sweep Examinations Targeted at Never-Before Examined Registered Advisers

In its 2014 National Examination Priorities, OCIE (now the Division of Examinations) initiated a program (the "NBE Initiative") targeted at advisers that have been registered for more than three years and have never been examined, and that are not part of the Presence Exam initiative.[274] The NBE Initiative is alive and well and registrants continue to be selected for examination based on a risk-assessment review and a focused review.[275] The risk-assessment review focuses on the adviser's compliance program and other documents that are necessary to assess the representations made in the adviser's disclosures.[276] For the focused review, inspectors will conduct "comprehensive, risk-based examinations" of any of the following areas that the Division of Examinations deems high risk: compliance programs, filings and disclosures, marketing, portfolio management, and safety of client assets.[277] After completion of the exam and if the adviser has deficiencies, then the Division of Examinations will send the adviser a letter identifying those deficiencies and the corrective action to be taken.[278] If the deficiencies are serious, then the Division of Examinations may refer to the matter to Enforcement or a state regulator for further action.[279] In 2015, OCIE extended this initiative to never-before-examined investment companies.[280] The Division of Examinations has continued this initiative and has included a focus on advisers that have been registered for a longer period of time but have never been examined.[281]

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[274] OCIE, National Exam Program, Examination Priorities for 2014, at 5 (Jan. 9, 2014).

[275] *See* Letter from Jane Jarcho, Nat'l Assoc. Dir., SEC IAIC Examinations, to Senior Executive or Principal of a Registered Investment Adviser, at 1 (Feb. 20, 2014).

[276] *Id.*

[277] *See id.* at 1–2.

[278] *See id.* at 2.

[279] *See id.* at 2.

[280] OCIE, National Exam Program, Examination Priorities for 2015, at 4 (Jan. 13, 2015).

[281] OCIE, National Exam Program, Examination Priorities for 2017 (Jan. 12, 2017). For OCIE's 2016 priority covering never before examined advisers and investment companies, see OCIE, National Exam Program, Examination Priorities for 2016 (Jan. 11, 2016).

B. Cybersecurity Guidance and Sweep Examinations

In February 2015, the Division of Examinations announced the results from the first phase of its cybersecurity initiative focused on investment advisers and broker-dealers.[282] Beginning in 2013 and over a one-year period, OCIE conducted sweep examinations of broker-dealers and investment advisers, focusing on: (1) identification of cybersecurity risks; (2) cybersecurity governance and policies and procedures; (3) network protection (e.g., external frameworks and standards, training, certain technical controls, certain metrics, training, and incident response plans ("IRPs")); (4) remote access to client information and fund transfer requests (e.g., informational material for client cybersecurity awareness and policies for addressing clients' cyber-related losses); (5) vendors and third parties; and (6) detection of unauthorized activity (including technical controls for that purpose).[283] OCIE's February 2015 announcement of the results from the cybersecurity sweep examination offers observations of industry cybersecurity practices (without any recommendations), which investment advisers (and broker-dealers) can use to review and enhance their cybersecurity programs.

In February 2015, FINRA released a cybersecurity report, which provides observations regarding broker-dealers' current cybersecurity practices, as well as recommendations from FINRA regarding effective cybersecurity practices for broker-dealers.[284] Although addressed to broker-dealers, the report's recommendations can be useful for advisers who are developing or evaluating the efficacy of their own cybersecurity programs.[285] In April 2015, the IM Division released a guidance update highlighting a number of measures that funds and advisers should consider when addressing cybersecurity risks.[286] In the guidance update, the IM Division staff recommended, among other things, that funds and advisers:

- periodically assess their data and technology systems, the cybersecurity threats to and vulnerabilities of their IT systems, their cybersecurity controls, the impact of a cybersecurity incident, and the adequacy of their governance framework;

- assess the cybersecurity risk posed by service providers with access to IT systems;

- develop and regularly test strategies that prevent, detect, and address cybersecurity threats by controlling access to data and systems, using encryption, restricting the use of removable storage media and monitoring for intrusions and data loss, implementing data backup and retrieval processes, and developing an incident response plan;

- implement training and policies and procedures that provide guidance to employees concerning the cybersecurity measures that are utilized. Further, such policies and procedures should be tailored towards the compliance obligations of the fund or adviser;

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[282] For the announcement of the results of the first phase of the cybersecurity initiative, see OCIE, National Exam Program, Risk Alert: Cybersecurity Examination Sweep Summary (Feb. 3, 2015) [hereinafter OCIE 2015 Risk Alert]. For the announcement of the cybersecurity initiative, see OCIE, National Exam Program, Risk Alert: Cybersecurity Initiative (Apr. 15, 2014).

[283] *See* OCIE 2015 Risk Alert, at 1.

[284] *See* FINRA, Report on Cybersecurity Practices (2015).

[285] More extensive treatment of this topic is provided in Mayer Brown Legal Update, OCIE and FINRA Announce the Results of Cybersecurity Initiative (Mar. 25, 2015).

[286] IM Guidance Update 2015-02 (Apr. 2015).

- monitor their ongoing compliance with the cybersecurity policies and procedures. The staff also suggested that funds and advisers offer educational material to clients concerning cybersecurity risk mitigation; and

- consider obtaining cybersecurity insurance.

In September 2015 and again in January 2016, OCIE stated that it will commence the second round of its cybersecurity initiative.[287] As part of the second round, OCIE focused on the following areas of advisers' cybersecurity controls: (1) governance and risk assessment; (2) access rights and controls; (3) data loss prevention; (4) vendor management; (5) employee and vendor training; and (6) cybersecurity incident response. OCIE announced the results of this second round of exams in August 2017, generally finding better cybersecurity preparedness by investment advisers and broker-dealers as compared to the first sweep, but noting observed areas of weakness and examples of good controls they observed.[288]

In September 2017, the SEC's Enforcement Division announced the creation of a new "cyber unit" to focus on targeting cyber-related misconduct, including market manipulation.[289] In February 2025, the division announced that this unit would be replaced by the "Cyber and Emerging Technologies Unit", with a mission of protecting retail investors from bad actors in the emerging technologies space.[290] This new unit is intended to focus enforcement efforts on a number of issues, including (i) fraud committed using artificial intelligence, machine learning, social media, and other online sources, (ii) takeovers of retail brokerage accounts, (iii) regulated entities' compliance with cybersecurity rules and regulations, (iv) hacking of material non-public information, (v) fraud involving blockchain technology and crypto assets, (vi) public issuer fraudulent disclosure relating to cybersecurity, and (vii) other matters.[291]

C. Risk-Based (Formerly "Routine") Inspections

In addition to the new Presence Exams, the Division of Examinations is prioritizing its routine examination program based on its assessment of advisers' risk profile relative to all registrants. Helpfully for registrants, the Division of Examinations now publishes its National Examination Program Priorities, which covers many of the key topics of a "routine," risk-based inspection.[292]

On October 21, 2024, the Division of Examinations ("EXAMS" or the "Division") of the SEC released its examination priorities (the "2025 Priorities") for fiscal year 2025 (which started October 1, 2024). Over the course of 2025, the Division intends for its examinations to focus on the use of artificial intelligence ("AI")

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[287] OCIE, National Exam Program, Examination Priorities for 2016 (Jan. 11, 2016). For the September 2015 announcement, see OCIE, NEP Risk Alert, OCIE's 2015 Cybersecurity Examination Initiative (Sep. 15, 2015).

[288] OCIE, National Exam Program, Risk Alert: Observations from Cybersecurity Examinations (Aug. 7, 2017).

[289] Press Release, SEC, SEC Announces Enforcement Initiatives to Combat Cyber-Based Threats and Protect Retail Investors (Sept 25, 2017).

[290] Press Release, SEC, SEC Announces Cyber and Emerging Technologies Unit to Protect Retail Investors (Feb. 20, 2025).

[291] Press Release, SEC, SEC Announces Enforcement Initiatives to Combat Cyber-Based Threats and Protect Retail Investors (Sep. 25, 2017).

[292] *See* OCIE, National Exam Program, Examination Priorities for 2019 (Dec. 20, 2018); OCIE, National Exam Program, Examination Priorities for 2018 (Feb. 7, 2018); OCIE, National Exam Program, Examination Priorities for 2017 (Jan. 12, 2017); OCIE, National Exam Program, Examination Priorities for 2016 (Jan. 11, 2016); OCIE, National Exam Program, Examination Priorities for 2015 (Jan. 13, 2015); OCIE, National Exam Program, Examination Priorities for 2014 (Jan. 9, 2014); OCIE, National Exam Program, Examination Priorities for 2013 (Feb. 21, 2013).

and other emerging technologies (including digital engagement practices ("DEPs")), complex products, cybersecurity, outsourcing, private fund advisers, and compliance with new and amended SEC rules, such as the recent amendments to Regulation S-P and SEC rule changes relating to the securities industry's transition to a T+1 standard settlement cycle for most securities transactions.

AI, DEPs and Other Emerging Financial Technologies

EXAMS remains focused on registrants' use of automated investment tools, AI, DEPs and trading algorithms or platforms, and the risks associated with the use of these and other emerging technologies and alternative sources of data. With respect to AI, the Division will review whether registrants have implemented adequate policies and procedures to monitor and/or supervise their use of AI, including in relation to fraud prevention and detection, back-office operations, anti-money laundering ("AML") and trading functions, as applicable. For registrants using third-party AI models and tools, the staff will examine how registrants protect against loss or misuse of client records and information. Additionally, the Division intends to review the accuracy of registrants' representations regarding their AI capabilities and use of AI technology, with certain practices having been characterized as "AI washing." The Division's focus on firms' use of AI technology in investor interactions is not surprising given the SEC's July 2023 rule proposal relating to the use of predictive data analytics by broker-dealers and investment advisers, which has not been adopted to date and for which SEC Chair Gensler has indicated that the SEC may issue a re-proposal, as well as the historical regulatory focus on automated investment advice.

The Division also intends to examine firms employing DEPs, such as digital investment advisory services, recommendations and related tools and methods. These reviews will assess whether:

- representations are fair and accurate;
- operations and controls are consistent with disclosures;
- algorithms produce advice or recommendations consistent with investors' investment profiles or stated strategies; and
- controls to confirm that advice or recommendations resulting from DEPs are consistent with regulatory obligations to investors.

Information Security and Operational Resilience

Cybersecurity

EXAMS will review registrants' practices to prevent interruptions to mission-critical services and to protect investor information, records and assets, with particular attention on firms' cybersecurity policies and procedures, governance practices, data loss prevention, access controls, account management, and responses to cyber-related incidents (including those related to ransomware attacks). Additionally, such reviews will assess how registrants identify and address cybersecurity risks relating to the use of third-party products and services in registrants' essential business operations, including with respect to sub-contractors and any information technology ("IT") resources used by a registrant's business without the IT department's approval, knowledge or oversight. This examination focus reflects a continued interest by the SEC and its staff on cybersecurity-related risks, a topic for which the SEC has announced administrative proceedings and risk alerts, as well as proposed cybersecurity risk management rules for broker-dealers, investment advisers and other SEC registrants. Cybersecurity, including in the outsourcing context, also continues to be

a focus of the Financial Industry Regulatory Authority, Inc. ("FINRA").[293] Other Focus Areas will include the following topics:

- Regulations S-ID and S-P (Including Recent Amendments to Regulation S-P).
- Shortening of the Settlement Cycle to T+1.
- Crypto Assets.
- Regulation Systems Compliance and Integrity (SCI).
- AML.
- Additional Focus Areas by Registrant Type.
- Funding portals' recordkeeping practices, such as records related to investors who purchase securities, and issuers who offer and sell securities, through a funding portal.

Adherence to Fiduciary Standards of Conduct

EXAMS will examine investment advisers' adherence to their fiduciary standards of conduct, particularly with respect to recommendations of:

- high-cost products;
- unconventional instruments;
- illiquid and difficult-to-value assets; and
- assets sensitive to higher interest rates or changing market conditions, including commercial real estate.

The Division will also focus on dual registrants and advisers with affiliated broker-dealers, including in respect of: (1) assessing investment advice and recommendations regarding certain products to determine whether they are suitable for clients' advisory accounts; (2) reviewing disclosures to clients regarding the capacity in which such dual registrants and advisers with affiliated broker-dealers are providing advice to clients; (3) evaluating the appropriateness of account selection practices (e.g., brokerage versus advisory), including rollovers from existing brokerage accounts to advisory accounts; and (4) evaluating the sufficiency of conflict mitigation practices and disclosures of conflicts of interest.

In addition, the Division will review the impact of advisers' financial conflicts of interest on providing impartial advice and best execution, taking into account non-standard fee arrangements.

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[293] *See*, for example, FINRA's September 2024 Cybersecurity Advisory regarding increasing cybersecurity risks at third-party providers. FINRA, FINRA Cybersecurity Advisory – Increasing Cybersecurity Risks at Third-Party Providers (Sep. 9, 2024); *see also* Mayer Brown Legal Update, FINRA Highlights Increasing Cybersecurity Risks at Third-Party Providers (Oct. 7, 2024); and Mayer Brown Legal Update, SEC Division of Examinations Announces 2025 Exam Priorities (Nov. 4, 2024).

Effectiveness of Advisers' Compliance Programs

The Division will assess the effectiveness of advisers' compliance programs as required by Advisers Act Rule 206(4)-7, which mandates written policies and procedures, designation of a chief compliance officer, and annual reviews of compliance policies and procedures for adequacy and effectiveness of implementation. Examinations of compliance programs generally include certain core areas, such as marketing, valuation, trading, portfolio management, disclosure and filings, and custody. In addition, examinations on this topic typically will include an analysis of advisers' annual compliance reviews, which the Division says are critical in monitoring conflicts of interests. In this connection, the staff called out specific types of conflicts, notably including conflicts stemming from arbitration clauses.8

The Division also stated that if clients invest in illiquid or difficult-to-value assets, such as commercial real estate, the staff may have a heightened focus on valuation.

Additional areas of focus for the Division's examinations may include:

- fiduciary obligations of advisers that outsource investment selection and management;
- supervision and oversight practices of advisers that utilize a large number of independent contractors working from geographically dispersed locations;
- if AI is integrated into advisory operations (including portfolio management, trading and marketing), in-depth review of related compliance policies and procedures, and disclosures (see also AI section above);
- alternative sources of revenue or benefits advisers receive, such as selling non-securities based products to clients; and
- lastly, EXAMS also intends to focus on the appropriateness and accuracy of fee calculations, and the disclosure of fee-related conflicts, such as those associated with select clients negotiating lower fees when similar services are provided to other clients at a higher fee rate.

Advisers to Private Funds

At the outset, and as we expected, the 2025 Priorities with respect to advisers to private funds reflect, at least in part, the consequences of the private fund rulemaking being vacated by the Fifth Circuit.[294]

Examinations of advisers to private funds will prioritize specific topics, such as the consistency of disclosures with actual practices, whether an adviser met its fiduciary obligations during times of market volatility, and whether a private fund is exposed to interest rate fluctuations (e.g., investment strategies involving commercial real estate, illiquid assets and private credit). The Division will focus in particular on advisers to

[294] On June 5, 2024, a three-judge panel of the Fifth Circuit Court of Appeals unanimously vacated the private fund rule adopted by the SEC, which would have caused significant changes to the regulation and operation of private fund advisers and the private funds themselves. Generally, these rule would have (1) restricted certain activities by private fund advisers that the SEC believed involved conflicts of interest and compensation schemes that are contrary to the public interest and (2) imposed a host of new disclosure requirements on private fund advisers, similar in certain respects to the reporting requirements imposed on registered investment companies. The SEC estimated that compliance with the rule would cost private fund managers $5.4 billion and require millions of hours of employee time. For additional discussion on this topic, *see* Mayer Brown Legal Update, Fifth Circuit Vacates Private Fund Adviser Rules (Jun. 5, 2024).

private funds experiencing poor performance and significant withdrawals as well as private funds that hold more leverage or difficult-to-value assets.

In addition, the Division will review the accuracy of calculations and allocations of private fund fees and expenses (both fund-level and investment-level), particularly for valuation of illiquid assets, calculation of post-commitment period management fees, offsetting of such fees and expenses, and the adequacy of disclosures. Although a focus on fee calculations and allocations is not new, the specific reference to illiquid assets here and elsewhere (coupled with the references to commercial real estate) is notable. Also notable is the reference to post-commitment period fees, which echoes similar regulatory concerns regarding the fees that advisers charge during wind-down or similar periods.

Furthermore, echoing the now vacated private fund rulemaking, the Division stated that it will assess the disclosure of conflicts of interest and the adequacy of policies and procedures, focusing on areas such as:

- use of debt;
- fund-level lines of credit;
- investment allocations;
- adviser-led secondary transactions;
- transactions between funds and/or others;
- investments held by multiple funds; and
- use of affiliated service providers.

Compliance with recently adopted amendments to Form PF, as well as with the investment adviser marketing rule, also will be examined. Consistent with previous years, the Division will prioritize examinations of advisers that have never been examined, recently registered advisers, and those that have not been recently examined.

Investment Companies

EXAMS will examine RICs compliance programs, disclosures, and governance practices, including with respect to:

- fund fees and expenses, and any associated waivers and reimbursements;
- oversight of service providers (both affiliated and third-party);
- portfolio management practices and disclosures, for consistency with claims about investment strategies or approaches and with fund filings and marketing materials; and
- issues associated with market volatility.

The third bullet above indicates a continued focus on so-called "ESG" funds and strategies, and reflects an ongoing regulatory interest in consistency of actual practice with investment strategy claims.

EXAMS intends to continue monitoring developing areas of interest, such as RICs with commercial real estate exposure, and to prioritize examinations of funds that have never before been examined or have not been recently examined. EXAMS mentions commercial real estate within the investment adviser and investment company sections of the 2025 Priorities. It also mentioned "non-securities based" products and "unconventional" assets. While it is not surprising that any asset class that is unusual, particularly if it is illiquid or difficult to value, would receive additional regulatory attention, the call-outs on commercial real estate, other "non-securities based" products and unconventional assets (which presumably goes beyond crypto) should serve as fair warning to investment advisers and investment companies that they should expect EXAMS to focus on commercial real estate and other "unconventional" assets not only in the manner described in the 2025 Priorities, but also with respect to other applicable aspects of regulatory compliance.[295]

D. Risk-Targeted Sweep Examinations

When the Division of Examinations identifies a high-risk area about which it lacks sufficient industry information, the Division may institute a sweep examination designed to identify common problems and possible solutions. Sweep examinations have included a February 10, 2009 sweep to identify false or malicious market rumors; a February 13, 2009 sweep to examine custody of client assets with advisers or their affiliates; a 2010 sweep to examine social media policies and practices; a December 2011 sweep to examine private equity fund valuation practices; a 2012 sweep to examine advisers' use of expert networks; and a 2013 sweep to examine mutual fund fee arrangements and another targeting the alternative fund industry and how it is using certain private fund strategies in publicly-traded investments.[296] In 2013 and 2014, as well as in 2016, the Division of Examinations carried out sweep exams of firms' cybersecurity preparedness. Additionally, in December 2016, the Division of Examinations announced that it was launching the Multi-Branch Adviser Initiative to examine investment advisers operating out of multiple branch offices to determine whether they are in compliance with the federal securities laws in light of risks posed by the branch model.[297] In 2016, yet another sweep was undertaken to examine the supervision practices and compliance programs of registered investment advisers that employ individuals with a history of disciplinary events in the financial services sector.[298] In 2018, the Division conducted a limited-scope sweep to obtain an understanding of the various forms of electronic messaging used by investment advisers and their personnel, the risks of such use, and the challenges in complying with certain provisions of the Advisers Act.[299] In 2020, the Division conducted exams focused on investment advisers, registered investment companies and private funds offering ESG products and services to assess their incorporation of such investment approaches and related disclosures.[300] In 2021, the Division conducted sweep examinations of advisers associated with wrap fee programs focusing on the fulfillment of their fiduciary duty obligations, the adequacy of their disclosures and the effectiveness of their related compliance

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[295] For greater coverage of the 2025 examination priorities, *see* Mayer Brown, Legal Update: SEC Division of Examinations Announces 2025 Exam Priorities (Nov. 4, 2024).

[296] *See Reuters,* Sarah N. Lunch, U.S. SEC to Examine Fund Fees, Alternative Funds (Mar. 8, 2013).

[297] OCIE, National Exam Program, Risk Alert: Multi-Branch Adviser Initiative (Dec. 12, 2016).

[298] OCIE, National Exam Program, Risk Alert: Examinations of Supervision Practices at Registered Investment Advisers (Sep. 12, 2016).

[299] OCIE, National Exam Program, Risk Alert: Observations from Investment Adviser Examinations Relating to Electronic Messaging (Dec. 14, 2018).

[300] SEC Division of Examinations, Risk Alert: The Division of Examinations' Review of ESG Investing (Apr. 9, 2021).

programs.[301] In 2023, the Division launched a sweep exam of investment advisers requesting information on AI-related topics, including AI-related marketing documents, algorithmic models used to manage portfolios, third-party providers, compliance training, information related to back-up plans for system failures, reports on AI-related regulatory or legal issues, and disclosures specifically referencing AI.[302] Beginning in the same year, the Division also conducted a lengthy sweep of advisers' marketing rule compliance.[303] In 2024, the Division conducted a sweep related to the shortening of the trade settlement cycle to T+1 and firms' related operational and recordkeeping preparedness.[304]

E. For Cause or TCR Inspections

Since instituting the Division of Examinations "TCR" Hotline (Tips, Complaints and Referrals), for cause inspections may be based on:

- anonymous tips or rumors of trouble;
- receipt of a public complaint; or
- referrals from other regulatory authorities.

F. "CARs" Exams

The Division of Examinations has also initiated a new category of examination called CARs, or Corrective Action Reviews. These examinations apply to registrants examined within the past six months to a year where substantial compliance deficiencies were identified and the registrant promised to address and resolve outstanding issues. Advisers who have been found in a CARs exam to have failed to address material deficiencies timely should expect referrals from the Division to Enforcement. Unlike other adviser exams, CARs exams are surprise exams with no notice provided to registrants.

There are generally three possible results from any category of Division of Examinations inspection:

- clean bill of health;
- an examination results (f/k/a "deficiency") letter that informs adviser of any compliance observations, violations, or possible violations found by the Division of Examinations and requests that adviser respond to Staff regarding any corrective steps; or
- referral to enforcement – first step in initiating enforcement action.

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[301] SEC Division of Examinations, Risk Alert: Observations from Examinations of Investment Advisers Managing Client Accounts that Participate in Wrap Fee Programs (Jul. 21, 2021).

[302] Mayer Brown Legal Update, Securities and Exchange Commission Brings First Enforcement Actions Over "AI-Washing" (Apr. 15, 2024).

[303] Mayer Brown Legal Update, SEC Charges Five Registered Investment Advisers for Marketing Rule Violations (Apr. 17, 2024).

[304] Mayer Brown Legal Update, SEC Division of Examinations Announces 2025 Exam Priorities (Nov. 4, 2024).

G. International Cooperation

Starting in the late 1980s, the SEC embarked on a path of cross-border cooperation, entering into bilateral memoranda of understandings ("MOUs") with approximately 80 separate jurisdictions and a Multilateral MOU under the auspices of the International Organization of Securities Commissions ("IOSCO") to facilitate the sharing of information between the SEC and other securities regulators in securities enforcement matters. The SEC's enforcement cooperation arrangements detail procedures and mechanisms by which the SEC and its counterparts can collect and share investigatory information where there are suspicions of a violation of either jurisdiction's securities laws, and after a potential problem has arisen.

Since 2006, the SEC has also entered into several "supervisory cooperation arrangements" ("supervisory MOUs") with foreign counterparts to establish mechanisms for continuous and ongoing consultation, cooperation, and exchange of supervisory information related to the oversight of globally active firms and markets. Shared information may include routine supervisory information as well as information needed to monitor risk concentrations, identify emerging systemic risks, and better understand a globally-active regulated entity's compliance culture. These arrangements also facilitate the ability of the SEC and its counterparts to conduct on-site examinations of registered entities located abroad. The first supervisory MOU was with the U.K.'s Financial Services Authority in March 2006. Following the 2008 financial crisis, the Commission has expanded its emphasis on this form of continuous supervisory cooperation in an effort to better identify emerging risks to U.S. capital markets and the international financial system. SEC commissioners and staff co-chaired an international task force in 2010 to develop principles for cross-border supervisory cooperation which have since been used as a guideline for structuring MOUs around the type of information to be shared, the mechanisms which regulators can use to share information, and the degree of confidentiality this information should be accorded. Among others, MOUs have been established with the Cayman Islands Monetary Authority (CIMA), the European Securities and Markets Authority (ESMA), the Quebec Autorité des marchés financiers, and the Ontario Securities Commission (created in 2010 and expanded in September 2011 to include the Alberta Securities Commission and the British Columbia Securities Commission).[305]

XIII. SEC ENFORCEMENT TOOLS AVAILABLE AGAINST ADVISERS

A. Sanctions

The SEC is empowered to censure an adviser, to place limitations on its activities, functions, or operations or to suspend (for a period not exceeding twelve months) or revoke the registration of any adviser (or any associate of the adviser, regardless of when the person became associated with the adviser) if it finds certain specified violations, listed below, and the sanction is "in the public interest."[306] Dodd-Frank Section 925 amended Section 203(f) of the Advisers Act to allow the SEC to impose "collateral bars" such that an adviser found to have violated the Act may be suspended or barred from being associated with an "investment adviser, broker, dealer, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization."[307] In addition, the SEC may impose civil money penalties in

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[305] Additional information about SEC cooperation arrangements with foreign regulators can be found at http://www.sec.gov/about/offices/oia/oia_cooparrangements.shtml.

[306] Section 203(e).

[307] *See* 124 Stat. at 1851, Section 925(b), "Collateral Bars. Investment Advisers Act of 1940."

administrative proceedings of up to $100,000 for any individual and up to $500,000 for any entity.[308] Furthermore, the SEC may issue cease-and-desist orders against any person who is violating, has violated or is about to violate or who causes a securities law violation by negligence or failure to act. Temporary cease-and-desist orders are also available and, in some cases, on an ex-parte basis.[309] The SEC also has the authority to order accounting and disgorgement of profits resulting from securities law violations, as well.[310] Sanctions applicable to investment advisers also may be made applicable to individuals associated with or seeking to be associated with an investment adviser.[311]

Pursuant to Section 203(e), these sanctions may be imposed upon an investment adviser if it has committed any of the following acts:

- if the adviser has willfully made a false or misleading statement, or omission of material fact in any application to (or proceeding before) the SEC;

- if the adviser has been convicted within ten years preceding the filing of any application with the SEC, or any time thereafter of any felony or misdemeanor or of a substantially equivalent crime by a foreign court of competent jurisdiction involving: (a) the violation of a fiduciary duty or fraud in a general business or securities context; (b) larceny, theft, robbery, extortion, forgery, counterfeiting, fraudulent concealment, embezzlement, fraudulent conversion, or misappropriation of funds or securities, or substantially equivalent activity however denominated by the laws of the relevant foreign country; or (c) the violation of Section 152 (concealment of assets, false oath and bribery), 1341, 1342, or 1343 (general fraud, mail and wire fraud), chapter 25 (counterfeiting, forgery) or 47 (fraud, false statements to defraud U.S.) of title 18, United States Code or a violation of any substantially equivalent foreign statute;

- if the adviser is permanently or temporarily enjoined by a court from engaging in a securities business, or from acting as an adviser, broker-dealer, underwriter, municipal securities dealer, or an affiliated person or employee of any investment company, bank, or insurance company;

- if the adviser has willfully violated or is unable to comply with any provisions of the federal securities laws, or has willfully aided, abetted, counseled, commanded, induced, or procured the violation by any other person of the federal securities laws;

- if the adviser is subject to an SEC order barring the person from being associated with an investment adviser; or

- if the adviser has been found by a foreign financial authority to have: (a) filed a false or misleading registration or report to such authority, or in any proceeding before such authority; (b) violated any foreign statute or regulation regarding securities or commodities transactions subject to the rules of a contract market or any board of trade; or (c) aided, abetted, counseled, commanded, induced,

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[308] Section 209(e).

[309] Section 203(k).

[310] Sections 203(j), (k)(5). The Supreme Court has clarified that the SEC's ability to seek disgorgement is a penalty, and accordingly is subject to a five-year statute of limitations. *Kokesh v. SEC*, 137 S.Ct. 1635 (2017). Under Section 21A (a)(2) of the 1934 Act, in insider trading cases, the SEC may recover up to three times the amount of profit gained or loss avoided.

[311] Section 203(f).

or procured the violation by any other person of any foreign statute regarding securities or commodities transactions, or found by such authority to have failed to reasonably to supervise another person who commits such violation.

B. Criminal Penalties

The Act provides courts with the authority to impose a fine up to $10,000 and/or imprisonment of up to five years for willful violations of the Act.[312] In addition, under a separate statute, an organization may be fined as much as the greater of: (a) twice the gross gain of the defendant or (b) twice the gross loss to any person other than the defendant.[313]

Reduction in Enforcement Power

In *SEC v. Jarkesy*,[314] the Supreme Court limited the SEC's administrative adjudication of certain securities fraud cases, holding that such adjudication of civil penalties violates the Seventh Amendment right to a jury trial. The SEC brought an enforcement action against George Jarkesy, Jr. and Patriot28, LLC under Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. The SEC levied sanctions against Jarkesy, which included a $300,000 civil penalty. penalties. As a result, the SEC staff must handle any investigative matters arising from alleged securities fraud, The holding curtails the SEC's ability to use in-house tribunals when seeking civil and if settlement is not achieved, the case will go before a federal judge and a jury.

Deepening Circuit Split on "Asset Freeze Tests"

For SEC-initiated asset freezes, the Second Circuit has required the SEC only make a substantial showing of likelihood of success as to both (i) a current violation of securities law and (ii) the risk of repetition of securities law violations. The Second Circuit reasoned that such injunctions serve only to preserve the SEC's opportunity to collect funds. This is a less stringent standard than the four-part test typically required for granting preliminary injunctions.

Earlier this year in *Chappell v. SEC*, the Third Circuit ruled that the SEC must show it would be likely to succeed on its securities violation claims, but the Third Circuit expanded their analysis to consider the irreparable harm, balancing of the equities, and public interest elements of the generally applicable preliminary injunction test. [315]

The Third Circuit's conclusion is at odds with the New York-based Second Circuit and more stringent than the First Circuit, which requires the SEC show likelihood of success on their violation claim as well as consider irreparable harm.

Interagency Securities Council (ISC)

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[312] Section 217.

[313] *See* 18 U.S.C. § 3571(d). For more information on the criminal penalties that can arise from violations of the Act and its related rules, see the U.S. Sentencing Guidelines, adopted under 28 U.S.C. §994(p), which provide judges with a complex eight-step analysis for sentencing organizations convicted of federal offenses.

[314] *SEC v. Jarkesy et al.*, No. 22-859 slip op. (Jun. 27, 2024).

[315] *SEC v. Chappell*, No. 23-2776 (3d Cir. 2024).

The SEC launched the ISC[316] to strengthen the cohesion between federal, state, and local agencies, enhance opportunities to collaborate on cases to protect investors, provide insight and guidance across the ecosystem to those who may not frequently operate in this space, and create a forum for unified efforts in combatting financial fraud.

C. Bad Actor Disqualification under Regulation D

Under Rule 506 of Regulation D, the SEC disqualifies from the safe harbor any offering in which certain bad actors are involved.[317] The exemption under Rule 506 of Regulation D is often used by private funds. Under Rule 506(d), an issuer may be prohibited from relying on Rule 506 if, among other things, its investment adviser had a disqualifying event.[318] The following are considered disqualifying events:

- a felony or misdemeanor, within ten years before the subject sale (five years for issuers, their predecessors, and affiliated issuers), in connection with the purchase or sale of any security, a false filing with the SEC, or the conduct of an underwriter, broker, dealer, municipal securities dealer, investment adviser, or paid solicitor of purchasers of securities;

- a court order entered within five years of the subject sale that at the time of the sale restrains or enjoins the person from engaging in any conduct in connection with the purchase or sale of any security, a false filing with the SEC, or the conduct of an underwriter, broker, dealer, municipal securities dealer, investment adviser, or paid solicitor of purchasers of securities;

- final order from certain state regulators, the CFTC, or the NCUA that, at the time of the sale, bars the person from association with an entity regulated by such authority, engaging in activities related to securities, insurance, banking, savings associations, or credit unions, or that constitutes a final order entered within ten years before such sale, based on a violation of a law that prohibits fraudulent, manipulative, or deceptive conduct;

- SEC disciplinary order that, at the time of the sale, suspends, or revokes the person's registration as a broker, dealer, municipal securities dealer, or investment adviser, that limits the person's activities or involvement, or that bars the person from participating in the offering of penny stock;

- SEC cease and desist order within five years of the sale that pertains to a future violation of a scienter-based, anti-fraud provision of the federal securities laws or that relates to Section 5 of the 1933 Act;

- suspension or expulsion from an SRO, or suspension or prohibition from association with a member of an SRO for conduct considered inconsistent with just and equitable principles of trade;

- SEC stop order within five years of the sale and that arose out of a violation of a registration statement or a Regulation A offering statement for which that person was an underwriter or the

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316 Press Release, SEC, SEC Launches Interagency Securities Council to Coordinate Enforcement Efforts Across Federal, State, and Local Agencies (Jul. 19, 2024).

317 Securities Act Rule 506(d).

318 The "bad actor" prohibition extends to investment advisers, because the prohibition includes the following private offering participants: general partners and managing members of the fund; investment managers (including the principals of the managers) to pooled investment funds; and placement agents.

issuer, or if at the time of the subject sale, the person is under investigation for such a stop order; and

- USPS false representation order within five years of the sale or, at the time of the sale, the person is under a temporary restraining order or preliminary injunction for allegedly employing a scheme or device to obtain money or property through the mail by false representations.[319]

There are, however, exceptions to the disqualifying events listed above. Among other things, Rule 506 permits the SEC to grant (under certain conditions) relief from the bad actor prohibition, permits the agency or court that entered the order to advise against disqualification, and gives the issuer a reasonable care defense if it establishes that it did not know and that, despite the exercise of reasonable care, could not have known of a disqualifying event.[320] In 2015, the SEC's Division of Corporation Finance issued guidance setting forth the factors that SEC staff would consider when determining whether to grant a waiver from the Regulation D (and Regulation A) bad actor disqualifications.[321] SEC staff will consider, *inter alia*, the following factors:

- the nature of the violation or conviction and whether it involved the offer and sale of securities;
- whether the conduct involved a criminal conviction or scienter-based violation (i.e., intending to deceive, manipulate, or defraud), as opposed to a civil or administrative non-scienter based violation;
- who was responsible for the misconduct;
- the duration of the misconduct;
- remedial steps taken after the misconduct; and
- the impact if the waiver is denied.

The SEC staff and the Commission itself have exercised their authority on a number of occasions to grant waivers from the bad actor disqualification provision,[322] although it continues to be a subject of some controversy.[323]

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[319] Securities Act Rule 506(d)(1). For a more detailed discussion, *see* Mayer Brown Legal Update, SEC Disqualifies "Bad Actors" from Participating in a Rule 506 Offering (Jul. 17, 2013).

[320] The reasonable care defense requires that the issuer make a factual inquiry as to whether a disqualifying event exists. Further, the SEC expects the timeframe for that factual inquiry to be "reasonable in relation to the circumstances of the offering and the participants." *See* Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings, Release No. 33-9414, at 66 (Jul. 10, 2013).

[321] Div. of Corp. Fin., SEC, Waivers of Disqualification under Regulation A and Rules 505 and 506 of Regulation D (Mar. 13, 2015).

[322] *See, e.g.*, H.D. Vest Investment Securities, SEC No-Action Letter (Mar. 4, 2015); *In re* Oppenheimer & Co., Release No. 33-9712 (Jan. 27, 2015); *In re* Bank of Am., N.A., Release No. 33-9682 (Nov. 25, 2014); *In re* Citigroup Global Markets, Inc., Release No. 33-9657 (Sep. 26, 2014); *In re* Barclays Capital Inc., Release No. 33-9651 (Sep. 23, 2014); *In re* Wells Fargo Advisors, LLC, Release No. 33-9649 (Sep. 22, 2014); *In re* Dominick & Dominick LLC, Release No. 33-9619 (Jul 28, 2014); *In re* Credit Suisse AG, Release No. 33-9589 (May 19, 2014).

[323] *See*, *e.g.*, Daniel M. Gallagher, Comm'r, SEC, Remarks at the 37th Annual Conference on Securities Regulation and Business Law: Why Is the SEC Wavering on Waivers? (Feb. 13, 2015); Mary Jo White, Chair, SEC, Understanding Disqualifications, Exemptions and

XIV. 1934 ACT COMPLIANCE

A. Whistleblower Rule: Exchange Act Rule 21F

Dodd-Frank Section 922 authorizes the SEC to reward "whistleblowers," including employees of advisers, who voluntarily provide "original" information from 10 percent to 30 percent of monetary penalties when the penalties reach more than $1 million or a minimum of $100,000 – $300,000.[324] According to a Supreme Court opinion decided in March 2014, whistleblower protection also extends to employees of a mutual fund's private contractors and subcontractors (e.g., investment advisers, law firms and accountants).[325] Any whistleblower who believes he has suffered retaliation for providing information to the SEC may bring suit directly in federal court seeking reinstatement, two times back pay and litigation expenses, including attorneys' fees.[326] Whistleblowers have six years to bring suit after the date of the retaliation, or three years after the date on which the retaliation should have been known. Section 1057 extends whistleblower status to employees who engage in a protected act, such as providing information to the Consumer Financial Protection Bureau, when reporting allegations that they "reasonably believe" that their employers broke the law. Employers who take adverse action against a whistleblower must provide "clear and convincing" evidence to rebut the inference of retaliatory motive. For example, the SEC has found that an employer had a retaliatory motive when, after learning that the employee had reported compliance issues to the SEC, the employer effectively demoted the employee from head trader to compliance assistant and tasked the employee with investigating the conduct that he had reported.[327] Any whistleblower convicted of a criminal violation related to the underlying violation of the securities laws is ineligible for an award under the Dodd-Frank Act.

The SEC has issued implementing rules.[328] In order to encourage whistleblowers to report possible violations of the federal securities laws, the SEC implemented Rule 21F-17, which prohibits employers from "tak[ing] any action to impede an individual from communicating directly with the Commission staff about a possible securities law violation." In 2015, the SEC settled a number of enforcement actions against firms that violated Rule 21F-17 by including provisions in their confidentiality agreements or severance agreements that deterred employees from reporting misconduct to regulators.[329] During an examination, the Division of

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Waivers Under the Federal Securities Laws (Mar. 12, 2015). For a more in-depth discussion of Rule 506's bad actor provisions and the practical implications thereof, *see* Mayer Brown Legal Update, SEC Disqualifies "Bad Actors" from Participating in a Rule 506 Offering (Jul. 17, 2013).

[324] 124 Stat. at 1841, Section 922, "Whistleblower Protection." *See also*, 124 Stat. at 1739, Section 748, "Commodity Whistleblower Incentives and Protection," providing the same types of incentives and protections to whistleblowers under the Commodity Exchange Act.

[325] *See* Lawson v. FMR LLC, 571 U.S. 1, 1, 29 (2014).

[326] Dodd-Frank Section 922(h), 124 Stat. at 1845.

[327] *See* In re Paradigm Capital Mgmt., Release Nos. 34-72393, IA-3857 (Jun. 16, 2014).

[328] *See* Implementation of the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934, Release No. 34-64545 (May 25, 2011).

[329] *See*, *e.g.*, *In re* KBR, Inc., Release No. 34-74619 (Apr. 1, 2015) (employer's confidentiality agreement used during internal investigations contained a provision that prohibited employees from discussing any particulars of the investigation and threatened disciplinary action if there were such a discussion, and the agreement did not include a carve out for reporting to regulators); *In re* BlackRock, Inc., Exchange Act Release No. 79804 (Jan. 17, 2017) (employer used a form separation agreement that included a provision requiring departing employees to waive recovery of whistleblower incentives, in exchange for receiving monetary separation payments); *In re* Health Net, Inc., Release No. 34-78590 (Aug. 16, 2016) (employer improperly used severance agreements to require its departing employees to agree not to apply for or accept an SEC whistleblower award); *In re* BlueLinx Holdings Inc., Release No. 34-78528 (Aug. 10, 2016) (employer's severance agreements prohibited employees from providing

Examinations staff may look at compliance manuals, codes of ethics, employment agreements, and severance agreements to determine whether they include provisions that limit the types of information that an employee may convey to the SEC or other authorities, or require departing employees to waive their right to a whistleblower award.[330]

To be eligible for an award, information reported internally must also be reported to the SEC within 120 days. Minor wrongdoers may collect awards on monetary sanctions, so long as the bounty deducts the amount of the sanctions imposed on or caused by the whistleblower.[331] Additionally, a reward to a whistleblower may be reduced if the SEC finds that the whistleblower unreasonably delayed his or her reporting. For example, if a whistleblower were to become aware of ongoing violations at the firm while employed there and were to report only after his or her employment with the firm ended, then the SEC will likely reduce the award paid to the whistleblower due to this delay.[332]

SEC Rule 21F-4(b)(4) defines "original" information in a way that allows a firm to rely on compliance personnel to keep damaging information confidential, but only if the firm self-reports. Information will not be considered "original" if derived from sources related to compliance functions, such as communications subject to the attorney-client privilege, or through the performance of an independent audit. Information is also not "original" if it was obtained by an employee or independent contractor "whose principal duties involve compliance or internal audit responsibilities;" unless certain exceptions apply, including when the designated person has a reasonable basis to believe that disclosure of the information to the Commission is necessary to prevent the firm from engaging in conduct that is likely to cause substantial injury to the financial interest or property of the entity or investors or after at least 120 days have elapsed since the whistleblower provided the information to the audit committee, chief legal officer, or chief compliance officer (or their equivalents) of the firm.

In 2024, the SEC's whistleblower enforcement sweep resulted in several settlements with several investment advisers. In one such action, an investment adviser regularly asked retail clients entering a settlement agreement with the investment adviser to enter confidentiality agreements that required the clients to keep confidential the settlement, all underlying facts relating to the settlement, and all information relating to the account at issue. In addition, even though the agreements permitted clients to respond to SEC inquiries, they did not permit clients to voluntarily contact the SEC. The investment adviser paid $18 million civil penalty, which is the largest penalty in a standalone 21F-17 case to date.[333] In another enforcement action,

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information pursuant to a legal process unless they had given notice to the employer or obtained the consent of the employer's legal department, but failed to include a carveout allowing employees to provide information voluntarily to the SEC or other regulatory or law enforcement agencies).

330 The following provisions, if included in a registrant's documents, may contribute to a finding that the registrant violated the whistleblower rules: (a) requiring employees to represent that they have not assisted in an investigation involving the registrant; (b) prohibiting all disclosures of confidential information, without exception, for voluntary communications to the SEC concerning possible federal securities law violations; (c) requiring employees to give notification or obtain authorization before disclosing confidential information, without exception, for voluntary communications to the SEC concerning possible federal securities law violations; and (d) permitting disclosures of confidential information only as required by law, without exception, for voluntary communications to the SEC concerning possible federal securities law violations. *See* OCIE, National Exam Program, Risk Alert – Examining Whistleblower Rule Compliance (Oct. 24, 2016).

331 *See* SEC Rule 21F-16.

332 *In re* Claim for Award, Release No. 34-76338 (Nov. 4, 2015); Press Release, SEC, SEC Announces Whistleblower Award of More Than $325,000 (Nov. 4, 2015).

333 *In re* J.P. Morgan Securities LLC, Release No. 99344 (Jan. 16, 2024).

In re GQG Partners LLC (Sep. 2024), the investment adviser entered into non-disclosure agreements with 12 candidates for employment that prohibited them from disclosing confidential information about GQG Partners LLC including to government agencies. While the agreements permitted the candidates to respond to requests for information from the Commission, it required notification to GQG Partners LLC of any such request and prohibited responding to requests arising from a candidate's voluntary disclosure.[334] Additionally, the SEC settled with broker-dealer Nationwide Planning and two affiliated investment advisers for similar violations, paying combined fines of $240,000. The SEC also separately settled with seven public companies in September 2024, totaling more than $3 million in additional fines.[335]

The SEC awarded over $255 million to 47 individual whistleblowers in the 2024 fiscal year. This is down somewhat from 2023, which had a record-breaking year for the Whistleblower Program, with awards issued of nearly $600 million, the most ever awarded in one year. The SEC received more than 18,000 whistleblower tips, 50 percent more than in 2022 (which was also a record-breaking year for such tips). But this tip-trend is on the rise as the SEC reported that it received nearly 25,000 whistleblower tips in 2024.

B. Liability for Misstatements and Omissions

Rule 10b-5, promulgated under Section 10(b) of the 1934 Act, makes it unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange:

- to employ any device, scheme, or artifice to defraud;
- to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading; or
- to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.[336]

In 2011, the Supreme Court concluded that liability for untrue statements applied only to those persons with "ultimate authority" over the statements.[337] In other words, an investment adviser who drafted a communication with untrue statements—in this case, a fund prospectus—would not be liable under Rule 10b-5(b) (the antifraud provision at issue in the case), because the investment company (not the adviser) filed the prospectus with the misstatements. The investment company had "ultimate authority" over the prospectus and was the "maker" of the untrue statements. It was unclear whether the Supreme Court's

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[334] *In re* GQG Partners LLC, Release No. 101200 (Sep. 26, 2024).

[335] *See* Press Release, SEC, SEC Charges Broker-Dealer Nationwide Planning and Two Affiliated Investment Advisers with Violating Whistleblower Protection Rule (Sep. 4, 2024).

[336] This potentially includes even the charitable donation of securities for an increased tax benefit. In a 2002 complaint, the SEC argued that one of the defendants (an executive officer) had violated Section 10(b) and Rule 10b-5 by, *inter alia*, donating stock to charities prior to his company's announcement that its results had been inflated during that defendant's tenure at the company and, thus, the defendant realized an increased tax benefit on that stock. *See* Complaint, *SEC v. Buntrock et al.*, No. 02C-2180, ¶¶ 342, 346 (N.D. Ill. Mar. 26, 2002); *see also* SEC v. Buntrock, No. 02 C 2180, Fed. Sec. L. Rep. ¶ 92,833 (N.D. Ill. May 25, 2004). The defendant later settled with the SEC and, among other things, agreed to disgorge the "$700,000 in tax benefits realized by [him] from gifting stock that was inflated by the fraud." *SEC v. Buntrock*, Litigation Release No. 19351 (Aug. 29, 2005).

[337] *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2302–05 (2011).

decision applied to other federal antifraud provisions. However, according to a 2014 opinion by the SEC Commissioners, the SEC can still pursue drafters (e.g., advisers and individual officers) for antifraud violations arising from their role in the preparation of a communication that contains misrepresentations or omissions as to a material fact.[338] In December 2015, this decision was overturned by the U.S. Court of Appeals for the First Circuit, which conducted a very fact specific analysis to reach its holding.[339] Because the First Circuit's opinion was very fact specific, it is likely that the SEC will continue to apply this broad construction to pursue drafters for misstatements.

C. Rule 10b-5 and Insider Trading

In addition to prohibiting material misstatements and omissions in securities transactions in which the seller and purchaser are known to each other, Rule 10b-5 has also been interpreted to prohibit "insider trading" in the securities markets, where the identities of sellers and purchasers are unknown to each other. The term "insider trading" is not defined in Rule 10b-5, but generally is used to refer to the use of material nonpublic information to trade in securities (whether or not one is an "insider") or to communications of material nonpublic information to others.

While the law concerning insider trading is not static, it is generally understood that the law prohibits:

- trading by an insider, while in possession of material nonpublic information;
- trading by a non-insider, while in possession of material nonpublic information, where the information either was disclosed to the non-insider in violation of an insider's duty to keep it confidential or was misappropriated; or
- communicating material nonpublic information to others.

It bears emphasis that the prohibition applies if a person is *in possession of* material nonpublic information with respect to an issuer. The SEC's position has been that the SEC need not prove that the trading was *on the basis of* the information.

The elements of insider trading and the penalties for such unlawful conduct are discussed below.

1. Who is an Insider?

The concept of "insider" is broad. It includes officers, directors and employees of a company, and it also (likely) includes the officers of an investment adviser that provides advisory services to the subject fund.[340]

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[338] John P. Flannery, Release No. IA-3981, at 19 (Dec. 15, 2014). An SEC ALJ has subsequently used the *Flannery* decision to find an individual liable for untrue statements, even when that individual was not the maker of the untrue statements. *See In re* Harding Advisory LLC, Admin. Proceeding No. 3-15574 (Jan. 12, 2015). It is important to note that the SEC has agreed to review the ALJ's initial decision in the *Harding Advisory* matter. *See In re* Harding Advisory LLC, Release Nos. 33-9731, IC-31468, IA-4031 (Feb. 23, 2015). Further, Harding Advisory LLC and Wing Chau, the firm's CEO, have appealed an adverse ruling by a district court judge pertaining to whether the SEC's administrative action deprived them of their rights to due process and equal protection of the law.

[339] *John P. Flannery v. SEC*, Nos. 15-1080, 15-1117 (1st Cir. Dec. 8, 2015).

[340] *See SEC v. Bauer*, No. 03-C-1427 (E.D. Wis. Aug. 29, 2014). In *Bauer*, the district court concluded that the SEC had failed to show how Jilaine Bauer, who was general counsel and CCO of the investment adviser to the mutual fund, could be fairly considered an "outsider" in relation to that mutual fund, "given the investment adviser's deeply entwined role as sponsor and external manager of the fund." It is important to note that the ultimate significance of this case is not entirely clear, since neither the district court

In addition, a person can be a "temporary insider" if he or she enters into a special confidential relationship in the conduct of a company's affairs and as a result is given access to information solely for the company's purposes. A temporary insider can include, among others, a company's attorneys, accountants, consultants,[341] bank lending officers, and the employees of such organizations. In addition, the company may become a temporary insider of a client company it advises or for which the company performs other services. According to the Supreme Court, the client company must expect the outsider to keep the disclosed nonpublic information confidential and the relationship must at least imply such a duty before the outsider will be considered an insider.[342]

2. What is Material Information?

Trading on inside information is not a basis for liability unless the information is material. Information is material if there is a substantial likelihood that a reasonable investor would consider it important in making his or her investment decisions, or if the information is reasonably certain to have a substantial effect on the price of a company's securities.[343] Information that officers, directors and employees should consider material includes, but is not limited to: dividend changes, earnings estimates, changes in previously released earnings estimates, significant merger or acquisition proposals or agreements, major litigation, liquidation proposals, and other unusual management developments.

Material information does not have to relate to a company's business. For example, in *Carpenter v. U.S.,* 108 U.S. 316 (1987), the Supreme Court considered to be material certain information about the contents of a forthcoming newspaper column that was expected to affect the market price of a security. In that case, a *Wall Street Journal* reporter was found criminally liable for disclosing to others the dates that reports on various companies would appear in the *Wall Street Journal* and whether those reports would be favorable or not.

3. What is Nonpublic Information?

Information is nonpublic until it has been effectively communicated to the market place. One must be able to point to some fact to show that the information is generally public. For example, information found in a report filed with SEC, or appearing in *The Wall Street Journal* or other publications of general circulation would be considered public.

4. Basis for Liability

a) Fiduciary Duty Theory

In 1980, the Supreme Court found that there is no general duty to disclose before trading on material nonpublic information, but that such a duty arises only where there is a fiduciary relationship. That is, there

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nor the Seventh Circuit ever had to rule on whether a fund *insider* (like Bauer) could in fact be found liable for insider trading under the facts of the case.

[341] In enforcement actions involving MFS and Goldman Sachs and a consultant employed by those firms, the SEC emphasized that a consultant can be an insider and that confidential information about government securities can be inside information. *See* Massachusetts Fin. Services, Release No. IA-2165 (Sep. 4, 2003); *see also* Goldman, Sachs & Co., Release No. 34-48436 (Sep. 4, 2003).

[342] *See Chiarella v. United States*, 445 U.S. 222 (1980).

[343] *See id. SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d. Cir. 1968).

must be a relationship between the parties to the transaction such that one party has a right to expect that the other party will either disclose any material nonpublic information or refrain from trading.[344]

In *Dirks v. SEC*, 463 U.S. 646 (1983), the Supreme Court provided alternate theories under which non-insiders can acquire the fiduciary duties of insiders: they can enter into a confidential relationship with the company through which they gain information (e.g., attorneys, accountants), or they can acquire a fiduciary duty to the company's shareholders as "tippees" if they are aware or should have been aware that they have been given confidential information by an insider who has violated his fiduciary duty to the company's shareholders.

However, in the "tippee" situation, a breach of duty occurs only if the tipper personally benefits, directly or indirectly, from the disclosure. The benefit does not have to be pecuniary, but can be a gift, a reputational benefit that will translate into future earnings, or even evidence of a relationship that suggests a quid pro quo. In *Salman v. United States*, the Supreme Court clarified that a tipper who gives confidential information to a "trading relative or friend" benefits personally, because "giving a gift of trading information is the same thing as trading by the tipper followed by a gift of the proceeds."[345]

b) Misappropriation Theory

Another basis for insider trading liability is the "misappropriation" theory, under which liability is imposed for trading while in possession of material nonpublic information that was stolen or misappropriated from any other person. In *U.S. v. Carpenter*, the Court found a columnist defrauded the *Wall Street Journal* when he stole information from newspaper and used it for trading in the securities markets. The misappropriation theory can be used to reach a variety of individuals not previously thought to be encompassed under the fiduciary duty theory. With some limitations, the Supreme Court upheld the SEC's expanded use of the misappropriation theory in *United States v. O'Hagan*, 117 S. Ct. 2199 (1997).

c) Misuse Theory (Internal Control Failures)

Some investment advisers may receive material non-public information through lawful means, but must protect against and prohibit the misuse of that information. In a recent enforcement action against *Sound Point Capital Management* (Aug. 2024), an investment adviser sold collateralized loan obligations ("CLOs") that included debt about which the firm possessed inside information. The investment adviser failed to consider whether such information was "material" as it related to the CLO tranches. During the period it traded the CLOs discussed above, the investment adviser lacked policies and procedures to prevent the misuse of material nonpublic information about the underlying debt.[346]

In a similar action, In re *Marathon Asset Management, L.P.* (Sep. 2024), an investment adviser had access to material non-public information through its participation in *ad hoc* creditors' committees. While the investment adviser had general material non-public information policies in place, they did not *specifically* address the risk of misuse of material non-public information received through the investment adviser's participation in such committees. Similar to the above enforcement action, the information at issue

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[344] *See Chiarella*, 445 U.S. at 222.

[345] 137 S.Ct. 420 (2016).

[346] *See In re* Sound Point Capital Management, Release No. 6737 (Aug. 30, 2024).

regarded a loan held by a CLO, and the investment adviser's policies and procedures did not restrict trading in the relevant CLO securities.[347]

In both of the above SEC enforcement actions, the investment advisers' failure to implement the proper internal controls led the SEC to find that the investment advisers *might* have misused the material non-public information—and that was enough to find the investment advisers violated Section 204A of the Advisers Act and other federal securities laws.

d) "Shadow Trading" Theory

In *SEC v. Panuwat*, the SEC won its first case using a "shadow trading" theory.[348] Pursuant to Section 10(b), the SEC found defendant-employee Panuwat liable for using highly confidential information to purchase securities in *another* similar company to the company acquired by his employer shortly before the public announcement of the acquisition of his company. The court found that Panuwat owed a duty to his employer under his employer's internal policies, his employment agreement, and the principles of agency law.

5. Penalties for Insider Trading

Penalties for trading on or communicating material nonpublic information are severe, both for individuals involved in such unlawful conduct and their employers. A person can be subject to some or all of the penalties below even if he or she does not personally benefit from the violation. Penalties include:

- civil injunctions;
- treble damages;
- disgorgement of profits;
- jail sentences;
- fines for the person who committed the violation of up to three times the profit gained or loss avoided, whether or not the person actually benefited; and
- fines for the company or other controlling person of up to the greater of $1,000,000 or three times the amount of the profit gained or loss avoided.[349]

D. Enforcement Focus (Historical Overview)

Investment advisers and investment companies have been a consistent area of SEC enforcement focus. Following the 2016 fiscal year's record-setting number of enforcement cases against investment advisers and investment companies,[350] during the first full year of the Trump administration, the SEC saw a decrease in the total number of enforcement actions, the number of standalone actions, and the total disgorgement

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[347] *See In re* Marathon Asset Management, L.P., Release No. 6737 (Sep. 30, 2024).

[348] *See Sec. & Exch. Comm'n v. Panuwat*, No. 21-CV-06322-WHO, 2024 WL 4602708, at *1 (N.D. Cal. Sep. 9, 2024).

[349] The administrative, civil and criminal sanctions under Rule 10b-5 are generally similar to those under the Advisers Act.

[350] Press Release, SEC, SEC Announces Enforcement Results for FY 2016 (Oct. 11, 2016).

and penalties ordered.[351] During fiscal year 2017, enforcement actions brought by the SEC dealt with mutual fund share class and other cases impacting retail investors, cyber-related misconduct, insider trading, and issuer reporting/auditor misconduct. Other topics that were the focus of enforcement actions for that year included the Foreign Corrupt Practices Act and "cryptocurrency" or "initial coin offerings." During fiscal year 2018, a significant number of the SEC's standalone enforcement actions involved investment advisory issues, securities offerings, and issuer reporting/accounting and auditing, which collectively comprised approximately 63% of the overall number of standalone actions. Enforcement actions relating to market manipulation, insider trading, and broker-dealer misconduct each comprised approximately 10% of the overall number of standalone actions in fiscal year 2018, as well as other areas.[352]

In contrast, under the Biden administration, enforcement interest ticked up noticeably and, in particular, involving investment advisers. In fiscal year 2023, the SEC obtained orders for $4.949 billion in financial remedies, the second highest amount in SEC history, following on record setting remedies ordered in 2022. Of the financial remedies in 2023, $3.369 billion went to disgorgement and prejudgment interest and $1.580 billion in penalties, with those amounts being the second highest in SEC history. 2023 was a record-breaking year for the Whistleblower Program, with awards issued of nearly $600 million, the most ever awarded in one year.

On November 22, 2024, the SEC announced that it pursued 583 total enforcement actions in fiscal year 2024, with orders for a record high $8.2 billion in financial remedies—though the total number of enforcement actions went down compared to fiscal year 2023. 431 actions were "stand-alone" actions, which was 14 percent less than in the prior fiscal year; 93 "follow-on" administrative proceedings seeking to bar or suspend individuals from certain functions in the securities markets based on criminal convictions, civil injunctions, or other orders, which was 43 percent less than the prior fiscal year; and 59 actions against issuers who were allegedly delinquent in making required filings with the SEC, which represented a decrease of 51 percent.[353]

For advisers, the SEC actively initiated and brought enforcement actions against investment advisers for noncompliance with the Marketing Rule,[354] for books and records violations associated with the use of off-channel communications,[355] material misleading statements about ESG products,[356] and more. Time will tell what enforcement themes will be pursued by the SEC under newly appointed SEC Chairman Paul Atkins in 2025.

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[351] Press Release, SEC, SEC Enforcement Division Issues Report on Priorities and FY 2017 Results (Nov. 15, 2017).

[352] Press Release, SEC, SEC Enforcement Division Issues Report on FY 2018 Results (Nov. 2, 2018).

[353] Press Release, SEC, Announces Enforcement Results for Fiscal Year 2024 (Nov. 22, 2024).

[354] *See* Mayer Brown Legal Update, 5 Takeaways From SEC's First Marketing Rule Action (Sep. 7, 2023); Mayer Brown Legal Update, SEC Charges Five Registered Investment Advisers for Marketing Rule Violations (Apr. 17, 2024); SEC Press Release (Apr. 12, 2024) stating that the SEC had brought charges against five investment advisers for violations of the Marketing Rule, following bringing charges against nine investment advisers for Marketing Rule violations in September of 2023.

[355] *See* Mayer Brown Legal Update, WhatsApp All Over Again: the SEC Brings More Recordkeeping Charges Against Broker Dealers and Investment Advisers for Off-Channel Communications (Feb. 13, 2024).

[356] *See* DWS Investment Management, Inc., IA Release No. 6432 (Sep. 25, 2023) and Goldman Sachs Asset Management, IA Release No. 6189 (Nov. 22, 2022).

E. 1934 Act Reporting

1. Section 16 Reporting and Disgorgement

1934 Act Section 16(a) requires reporting of ownership and changes in ownership by any director or officer of an issuer, or by a direct or indirect beneficial owner of more than ten percent of any class of equity security registered under 1934 Act Section 12 ("covered security"), to the SEC, the national securities exchange (if the security is registered with such exchange) and the issuer. For *reporting* purposes, an investment adviser with discretionary authority is treated as a beneficial owner of covered securities held in discretionary accounts and is, for purposes of the ten percent test, required to aggregate the shares of those securities held directly or indirectly, or in the accounts.[357] The securities held for certain classes of clients, however, need not be aggregated in determining the ten percent threshold.[358]

Section 16(a) and related rules were amended in August 2002 to meet the accelerated filing requirements of Section 403(a) of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley").[359] Initial statements of beneficial ownership of equity securities must be filed on Form 3 within ten days of becoming a director or officer, even if no securities are owned.[360] However, statements of changes in beneficial ownership must now be filed on Form 4 before the end of the second business day following the day on which the subject transaction was executed.[361] Other transactions not previously reported are noted in the annual statement (Form 5), which is filed within 45 days after the issuer's fiscal year end.[362] These reporting obligations are triggered irrespective of the profits made or the person's intent in making the transaction.

The SEC is giving increased attention to individuals' Form 4 reporting obligations. SEC staff are using quantitative data and algorithms to identify insiders who repeatedly file their reports late, and the Enforcement division has "streamlined" the process through which it brings enforcement actions.[363] In September 2024, the SEC announced settled administrative proceedings against twenty-three entities and individuals relating to failures to properly file or amend on a timely basis Schedules 13D and 13G and Forms 3, 4 and 5, with penalties amounting to more than $3.8 million in total.[364] This followed a similar set of proceedings in September 2023.[365] These proceedings are consistent with the SEC's approach over many years; in 2014, for example, the SEC settled administrative proceedings against thirty-three individuals (officers and directors) and companies regarding failures to properly file a Schedule 13D or 13G or failure to properly file a Form 4 (a thirty-fourth case is pending). On March 13, 2015, the SEC settled administrative

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[357] Rule 16a-1(a).

[358] This exemption is subject to the same type of condition in Rule 13d-1.

[359] Pub. L. No. 107-204, 116 Stat. 745 (2002).

[360] Rule 16a-3.

[361] *See* Ownership Reports and Trading by Officers, Directors and Principal Security Holders, Release No. 34-46421, 35-27563, IC-25720 (Aug. 27, 2002).

[362] Rule 16a-3.

[363] *See* Press Release, SEC, SEC Announces Charges Against Corporate Insiders for Violating Laws Requiring Prompt Reporting of Transactions and Holdings (Sep. 10, 2014).

[364] *See* Press Release, SEC, SEC Levies More Than $3.8 Million in Penalties in Sweep of Late Beneficial Ownership and Insider Transaction Reports (Sep. 25, 2024).

[365] *See* Press Release, SEC, SEC Charges Corporate Insiders for Failing to Timely Report Transactions and Holdings (Sep. 27, 2023).

proceedings against eight officers, directors, or major shareholders for failing to amend promptly the Schedule 13D forms to report plans to take certain public companies private.[366]

In addition, under 1934 Act Section 16(b), any director or officer of an issuer, or a direct or indirect beneficial owner of more than ten percent of covered securities is required to disgorge to the issuer any profit made, or loss avoided from any purchase and sale (or sale and purchase) of such issuer's stock within a six-month period ("short-swing profit"). This means that any two transactions of an opposite nature (i.e., a purchase and a sale) within any six-month period, however unrelated, may lead to recovery by the issuer of any profit realized, or loss avoided. For purposes of *disgorgement*, an investment adviser with discretionary authority for accounts holding covered securities has beneficial ownership of those securities only if the adviser has a "pecuniary interest" in the securities. "Pecuniary interest" does not include the right to receive advisory fees unless certain performance-based fees are involved. It should be noted that the "pecuniary interest" exception applies only to disgorgement obligations. It does not apply for purposes of the reporting requirements discussed above.

Amendments introduced by the SEC in 1996 to certain rules under 1934 Act Section 16(a) related to short swing profit recovery ("Short Swing Profits Recovery Rule") expanded the number of exempt transactions and simplified the short swing profit rules. Rules promulgated under Section 16(a) were amended to: (a) expand the definition of a derivative to include certain "cash only instruments"; (b) repeal the requirement that Form 4 be submitted for routine transactions; (c) require that exercises and conversions of derivatives be reported; and (d) permit joint reporting. The 1996 amendments also expanded the exemptions available for insider transactions and sought to reduce the cost of compliance with the rules. However, as a result of the requirements of Section 403 of Sarbanes-Oxley, 1934 Act Rule 16b-3 was amended to require disclosure of insider transactions within two business days on Form 4. In addition, the rules governing reinvestment plans were amended so that dividend or interest reimbursement plans do not have to be available on the same terms to all holders of a class of securities in order for the transactions to be exempt from the short swing profit recovery rule.

2. Section 13(d) Reporting

1934 Act Section 13(d) and related Rule 13d-1 provide that any person who acquires beneficial ownership of any equity security of a specified class[367] so as to become the beneficial owner of more than five percent of the class must, file a Schedule 13D with the SEC. In the alternative, certain classes of persons who would be obligated to file a Schedule 13D statement, including registered investment advisers, may file an abbreviated statement on Schedule 13G.[368]

In 2023, the SEC adopted amendments to its rules under Section 13(d) to shorten the deadlines for initial Schedule 13D and Schedule 13G filings and for amendments to such filings, clarify the Schedule 13D

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[366] *See* Press Release, SEC, Corporate Insiders Charged for Failing to Update Disclosures Involving "Going Private" Transactions (Mar. 13, 2015).

[367] "Equity security" in Rule 13d-1 includes any equity security of a class registered pursuant to Section 12 of the 1934 Act, any security of an insurance company exempt from registration pursuant to that Act, or any equity security issued by a registered closed-end investment company. Nevertheless, *non-voting* securities are not included in the definition.

[368] Rule 13d-1(b)(1). A condition of this exemption is that the securities are held in the ordinary course of business and not with the purpose or effect of changing or influencing the control of the issuer.

disclosure requirements with respect to derivative securities; and require that Schedule 13D and Schedule 13G be made using a structured, machine-readable data language.[369]

The statement filed with the SEC must contain certain information and exhibits, as required by Schedule 13D or a Schedule 13G, as applicable. For Schedule 13D, the initial filing is required to be made within five business days after acquiring beneficial ownership of more than five percent, and amendments are required for material changes in the facts set forth in the previous Schedule 13D within two business days after the triggering event. For Schedule 13G, there are timing distinctions among three types of filers (qualified institutional buyers, passive investors, and exempt investors) for initial filings and amendments:

- Qualified institutional investors should make the initial filing on the earlier of: (a) 45 days after the end of the calendar quarter in which the person's beneficial ownership exceeds 5% at quarter-end and (b) five business days after the end of the first month in which the person's beneficial ownership exceeds 10% at month-end. Additional amendments should be filed within five business days after the end of the first month in which a person's beneficial ownership exceeds 10% at month-end. Thereafter within five business days after the end of any month in which the person's month-end beneficial ownership increases or decreases by more than 5%.[370]

- Passive investors should make the initial filing within five business days after acquiring more than 5% beneficial ownership. Additional amendments should be filed within two business days after acquiring greater than 10% beneficial ownership. Thereafter, within two business days after the person's beneficial ownership increases or decreases by more than 5%.

- Exempt investors should make an initial filing within 45 days after the end of the calendar quarter in which a person's beneficial ownership exceeds 5% at quarter-end.[371]

- All filers are required to amend a Schedule 13G for material changes within 45 days after the calendar quarter-end in which such material change occurred. Notably, there are no longer annual amendments for qualified institutional buyers, passive investors, and exempt investors.[372]

An investment adviser with discretionary management authority is treated as having beneficial ownership of all the securities in discretionary accounts.[373] Those securities must be aggregated with the adviser's other direct and indirect ownership for purposes of determining the percentage limit.[374] In addition, the owner of each discretionary account with five percent or more in a covered security must file separately on Schedule 13D, or Schedule 13G, as applicable. As noted above, under the discussion about Section 16 reports, SEC staff are identifying repeatedly delinquent filers through the use of quantitative data and algorithms and the SEC has settled a number of administrative proceedings regarding failures to properly file a Schedule 13D, Schedule 13G, or Form 4 report.

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[369] *See* Press Release, SEC, SEC Adopts Amendments to Rules Governing Beneficial Ownership Reporting (Oct. 10, 2023).

[370] Rule 13d-1(b)(2).

[371] Rule 13d-1(c); 13d-1(d).

[372] *See* Rule 13d-1(b).

[373] Rule 13d-3(a).

[374] Rule 13d-3(c).

In 2009, the SEC granted temporary no-action relief to Citigroup and Morgan Stanley with respect to these reporting requirements.[375] The then-unaffiliated parties were permitted to file consolidated reports during the period prior to finalizing acquisition and consolidation of the combined entity, Morgan Stanley Smith Barney, as a result of certain information sharing safeguards and coordinated investment and voting decisions between the businesses contributed by each, including the maintenance of information barriers to protect customer trading information party.

3. Rule 13f-1 Reporting

Advisers with investment discretion over $100 million or more of exchange-traded or Nasdaq securities must file a Form 13F within 45 days of each calendar quarter end, reporting: (a) name of issuer; (b) number of shares held; and (c) aggregate fair market value of each security held. If an investment adviser is concerned that certain Form 13F disclosures might reveal trade secrets or commercial or financial information obtained from confidential or privileged sources, then the adviser should file a confidential treatment request ("CT Request"). A CT Request, if granted, would delay or prevent the public disclosure of information the adviser considers confidential or privileged.[376] The SEC staff has recognized that a common concern of advisers that report via Form 13F is that the Form 13F disclosures could publicly reveal the adviser's ongoing program of acquisition or disposition of a Reportable Security. Accordingly, in October 2013, the SEC staff issued guidance that elaborates on the five categories of information required in a CT Request for data reported in a Form 13F filing that could reveal to the public an adviser's ongoing program of acquisition or disposition.[377]

13F filers also must prepare for new Form N-PX filing obligations.[378] This includes "institutional investment managers"[379] who file Form 13F with the SEC. Persons not required to file Form 13F are not required to file the new Form N-PX. Mutual funds and other registered investment companies will need to continue reporting all of their votes; however, they will do so on a new Form N-PX that will be used by both registered funds and covered managers.

Form N-PX disclosure is made separately by series and includes certain identifying information along with a summary page includes a required summary page, all in an effort to increase transparency for investors. Filers are also required to make proxy voting records available on a filer's public website, free of charge, and to file Form N-PX reports using XML structured data language. Additionally:

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375 *See* Morgan Stanley Smith Barney LLC, SEC No-Action Letter (May 29, 2009).

376 Form 13F Confidential Treatment Requests Based on a Claim of Ongoing Acquisition/Disposition Program, IM Guidance Update No. 2013-08, at 2 (Oct. 2013).

377 Those five categories are: (1) details about the acquisition/disposition program; (2) an explanation as to how the public could use the Form 13F data to discern the program; (3) information showing that the program is ongoing; (4) a demonstration of the likelihood of substantial harm; and (5) the period of time for which confidential treatment is requested.

378 Press Release, SEC, SEC Adopts Rules to Enhance Proxy Voting Disclosure by Registered Investment Funds and Require Disclosure of "Say-on-Pay" Votes for Institutional Investment Managers (Nov. 2, 2022).

379 An "institutional investment manager" is any person, other than a natural person, investing in or buying and selling securities for its own account as well as any person exercising investment discretion with respect to the account of any other person. *See* Securities Exchange Act Section 3(a)(9) and Section 13(f)(6)(A); *see also* SEC FAQ (May 25, 2023), *available at* https://www.sec.gov/rules-regulations/staff-guidance/division-investment-management-frequently-asked-questions/frequently-asked-questions-about-form-13f.

- Affiliates may file a single form under certain circumstance.
- A short-form filing is available when:
    - all proxy votes are reported by other reporting persons;
    - the filer did not exercise voting power for any reportable voting matter and therefore does not have any proxy votes to report; and
    - the filer has a clearly disclosed policy of not voting and did not actually vote on any proxy voting matters.

4. Rule 13f-2 Reporting

Though Rule 13f-2 took effect January 2, 2024, the SEC recently extended a one-year grace period for compliance (lasting until January 2, 2026).[380] Rule 13f-2 regulates the reporting of certain short-sale investment activity, and requires institutional investment managers meeting or exceeding certain of thresholds to file Form SHO, which covers short-sale related data, with the SEC within fourteen days after the end of each month.[381] The SEC will aggregate the resulting data by security, thereby maintaining the confidentiality of the reporting managers, and publicly disseminate the aggregated data via EDGAR on a delayed basis. This SEC's goal is to allow this new data to supplement the short-sale data that is currently publicly available. This Rule 13f-2 is currently being challenged in the Fifth Circuit.[382]

5. Rule 13h-1 Reporting

In July 2011, the SEC adopted Exchange Act Rule 13h-1 and Form 13H to effectuate a large trader reporting system as permitted by 1934 Act Section 13(h).[383] Rule 13h-1 defines "large trader", in pertinent part as, "any person that . . . directly or indirectly, including through other persons controlled by such person, exercises investment discretion over one or more accounts and effects transactions for the purchase or sale of any NMS security for or on behalf of such accounts, by or through one or more registered broker-dealers, in an aggregate amount equal to or greater than the identifying activity level. . . ." Advisers who come within the definition must file Form 13H. The SEC further defined "identifying activity level" as "aggregate transactions in NMS securities that are equal to or greater than: (1) during a calendar day, either two million shares or shares with a fair market value of $20 million or (2) during a calendar month, either twenty million shares or shares with a fair market value of $200 million." In addition, "NMS securities" basically means all exchange-traded securities, including options.

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[380] *See* Press Release, SEC, SEC Adopts Rule to Increase Transparency Into Short Selling and Amendment to CAT NMS Plan for Purposes of Short Sale Data Collection, No. 2023-221 (Oct. 13, 2023).

[381] *See* Press Release, SEC, Exemption From Exchange Act Rule 13f-2 and Related Form SHO (Feb. 7, 2025).

[382] *See* Nat'l Assoc. Priv. Fund Mgr. v. SEC, No. 23-60626 (5th Cir.)

[383] *See* Large Trader Reporting, Release No. 34-64976 (Jul. 27, 2011). 1934 Act Section 13(h) defines a "large trader" as "every person who, for his own or an account for which he exercises investment discretion, effects transactions for the purchase or sale of any publicly traded security or securities by use of any means or instrumentality of interstate commerce or of the mails, or of any facility of a national securities exchange, directly or indirectly by or through a registered broker or dealer in an aggregate amount equal to or in excess of the identifying activity level." The determination of "large trader" status under the new rule is complex. Do not rely on this summary to decide whether or not an advisory firm or parent company may be a large trader.

The chart below summarizes the filing responsibilities under 13D, 13G, 13F, and 13H.

Schedule 13D	Filed by any person who acquires, directly or indirectly, more than five percent of beneficial ownership of any equity security of a class registered pursuant to 1934 Act Section 12 or any equity security of an insurance company relying on Section 12(g)(2)(G) or any closed-end investment company registered under the Company Act. Must be filed within 5 business days after such acquisition with the SEC. Duty to amend 13D is found in 1934 Act Rule 13d-2. Amendments to be filed within two business days of any material change in previously reported information.
Schedule 13G	Filed in lieu of a Schedule 13D if person acquired securities in the ordinary course of business and not with purpose of changing or influencing control of issuer. If such person is a registered investment adviser, it may file Schedule 13G as a qualified institutional investor. *See* 1934 Act Rule 13d-1(b)(1) (ii)(E). Must be filed within 45 days after the end of the quarter in which the qualified institutional investor or exempt investor crosses the 5% threshold at quarter-end or within five business days of crossing the threshold for passive investors, and subsequent amendments are generally required within 45 days after the end of the quarter in which there are any material changes in the information last reported. Shorter deadlines apply to qualified institutional investors or passive investors whose beneficial ownership exceeds 10%. If the person no longer holds such securities in the ordinary course of its business, it must promptly file a Schedule 13D. Duty to amend 13G is found in Rule 13d-2. [384] "Beneficial ownership," as defined in Rule 13d-2, includes any person who directly or indirectly has or shares: (a) voting power, which includes the power to vote, or to direct the voting of such security; and/or (b) investment power, which includes the power to dispose, or to direct the disposition of such security.
Form 13F	Filed by investment manager that exercises investment discretion with respect to accounts holding equity securities having an aggregate fair market value of at least $100 million. Must file within 45 days of end of each quarter. For confidentiality issues (e.g., open-risk arbitrage positions), see 1934 Act Section 13(f)(3) and Part D of the General Instructions accompanying Form 13F.

[384] For all Schedule 13G filers, in the event that those filers subsequently fall below the filing threshold of 5%, they must file an amendment reflecting that change.

Form 13H	Filed by, among others, advisers with discretion over aggregate transactions in NMS securities equal to or greater than either: (1) either two million shares or shares with a fair market value of $20 million daily; or (2) either twenty million shares or shares with a fair market value of $200 million monthly. Filed through EDGAR, but not otherwise publicly available. Initial Filing is due "promptly," meaning, under normal circumstances, within 10 days after effecting aggregate transactions equal to or greater than the identifying activity level. Thereafter, Annual Filings due within 45 days after the end of each full calendar year unless large trader status is Inactive or Terminated. If information in a Form 13H becomes inaccurate, adviser must file an Amended Filing no later than promptly following the end of the calendar quarter in which the information became stale or more frequently quarterly at its discretion. Large Traders must self-identity their status to all executing B-Ds handling transactions for their accounts or clients.

XV. OTHER SUBSTANTIVE REGULATION

A. Anti-Money Laundering ("AML") Compliance Requirements

On August 28, 2024, the Financial Crimes Enforcement Network ("FinCEN") finalized a rule establishing AML compliance obligations for certain investment advisers (the "New AML Rule"). FinCEN largely adopted the substance of the proposed rule as proposed; however, there are several key differences between the two.[385]

Despite the fact that the statutory definition of "financial institution" under the Bank Secrecy Act ("BSA") is broad, FinCEN has generally applied the BSA's AML compliance obligations only to specific types of financial institutions for which FinCEN has established rules governing the related AML compliance obligations. Under the New AML Rule, FinCEN would exercise its authority to designate certain "investment advisers" as "financial institutions" for purposes of the BSA, thus imposing AML compliance obligations, and would establish the related rules governing those obligations.

Although FinCEN's proposal included within the definition of "investment adviser" all registered investment advisers ("RIAs") and exempt reporting Advisers ("ERAs"), FinCEN narrowed the scope of the definition in its final rulemaking. Under the New AML Rule, "investment advisers" that are required to register with the SEC on only one or more of the following bases, and have no other basis for registration, are exempt: (i) mid-sized advisers, which are generally RIAs with between $25 million and $100 million of assets under management ("AUM"); (ii) multistate advisers, which are investment advisers with less than $100 million of AUM that would be required to register with the state securities authorities of at least 15 states, but have chosen instead to register with the SEC; (iii) pension consultants; or (iv) RIAs that do not report any regulatory AUM on the adviser's most recently filed Form ADV. The New AML Rule also does not include state-registered investment advisers (which FinCEN notes it will continue to monitor for indicia of illicit

[385] *Compare* Financial Crimes Enforcement Network: Anti-Money Laundering/Countering the Financing of Terrorism Program and Suspicious Activity Report Filing Requirements for Registered Investment Advisers and Exempt Reporting Advisers, 89 Fed. Reg. 12108 (Feb. 15, 2024), *with* Financial Crimes Enforcement Network: Anti-Money Laundering/Countering the Financing of Terrorism Program and Suspicious Activity Report Filing Requirements for Registered Investment Advisers and Exempt Reporting Advisers, 89 Fed. Reg. 72156 (Sep. 4, 2024).

activity), exempt foreign private advisers (including foreign-located private advisers with non-US activities as described below), or excluded family offices.[386]

The New AML Rule imposes compliance obligations on SEC advisers "wherever located," including those located outside the United States, but imposes limitations on the types of activities that are subject to the New AML Rule. Specifically, the New AML Rule defines a "foreign-located investment adviser" as an investment adviser whose principal office and place of business is outside the United States and limits the application of the New AML Rule to advisory activities of a foreign-located investment adviser that: (i) take place within the United States, including through involvement of US personnel of the investment adviser or (ii) provide advisory services to a US person or a foreign-located private fund with a US person investor. For purposes of these descriptions, the New AML Rule incorporates definitions and standards from the SEC for identifying US-person investors in foreign-located private funds. This scoping is similar to, but not entirely the same as, the SEC's historical position that the substantive provisions of the Advisers Act should generally not apply to foreign-located investment advisers' dealings with non-US clients.

Notably, the AML Rule does not require SEC Advisers to identify and verify client identities through a formal Customer Identification Program ("CIP") and does not require such advisers to collect details about who ultimately owns the legal entity customers the adviser works with (beneficial ownership information). FinCEN anticipates addressing (i) CIP requirements in a joint rulemaking with the SEC, and (ii) beneficial ownership requirements in connection with its obligation to update its existing Customer Due Diligence ("CDD") Rule, in accordance with the specific beneficial ownership requirements set forth in the Corporate Transparency Act ("CTA").[387] Although not part of the AML Rule, FinCEN invited comment on the issue of whether SEC Advisers should be subject to the beneficial ownership requirements of its forthcoming revision to the CDD rule.[388]

Since 2002, investment advisers have not been subject to direct AML compliance obligations, although many are familiar with parts of the AML framework due to their relationships with banks, securities broker-dealers, futures commission merchants, introducing brokers in commodities, and mutual funds, all of which

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386 31 CFR Parts 1010 and 1032.

387 Bank Secrecy Act, Pub. L. 91-508 § 121, 84 Stat. 1114 (Oct. 26, 1970), codified at12 U.S.C. § 1951et seq.

388 On July 8, 2024, FinCEN issued guidance explaining that the beneficial ownership information reporting requirement applies to certain legal entities that have been dissolved or otherwise ceased to exist after January 1, 2024. This new guidance dramatically expands the reporting requirement under the Corporate Transparency Act and raises significant issues regarding compliance and liability for noncompliance. Persons who own or manage entities that will dissolve in 2024, or have already dissolved this year—or which were not dissolved irrevocably—should review the guidance to determine their reporting obligations. For additional discussion, please *see* Mayer Brown Legal Update, FinCEN Requires Reporting from Dissolved Companies (Jul. 8, 2024). FinCEN has drastically altered the scope of the CTA by interim rulemaking, exempting all domestic reporting companies. Although this interim rule does not change the definition of "beneficial ownership," how FinCEN updates the CDD rule remains an open question. *See* FinCEN, FinCEN Removes Beneficial Ownership Reporting Requirements for U.S. Companies and U.S. Persons, Sets New Deadlines for Foreign Companies (Mar. 21, 2025).

are subject to extensive AML compliance obligations. The New AML Rule changes the status quo, fulfilling FinCEN's long-stated goal of imposing AML compliance obligations on certain investment advisers.[389]

B. Treasury International Capital ("TIC") Reporting

The U.S. Department of the Treasury ("Treasury") collects information from certain investment managers, funds and custodians (collectively "Reporting Entities") on Forms SLT, SHC and S,[390] part of the Treasury International Capital ("TIC") reporting system. The TIC reporting system collects data on cross-border portfolio investment flows and positions between U.S. residents (including U.S.-based branches of firms headquartered in other countries) and foreign residents (including offshore branches of U.S. firms).[391]

1. Form SLT

Form SLT, for Aggregate Holdings of U.S. Long-Term Securities by Foreign Residents and Holdings of Foreign Long-Term Securities by U.S. Residents, is a holdings report that requires monthly completion and filing[392] with the Federal Reserve Form SLT by Reporting Entities that meet the filing threshold. It is primarily a custodian filing, but advisers deemed to have custody of certain securities must file on behalf of themselves and their end-investors. For example, foreign securities owned by a U.S.-resident end-investor that are not entrusted to an unaffiliated U.S.-resident custodian that knows the identity of the actual end-investor should generally be reported by the U.S. investment manager of the end-investor. U.S. securities owned by a foreign-resident end-investor held in an omnibus customer account in the name of a U.S. adviser should be reported by the adviser as custodian. Filing is required by Reporting Entities having either aggregate holdings of foreign long-term debt and equity securities (excluding direct investments) totaling more than $1 billion or aggregate U.S. holdings for foreign residents of more than $1 billion. Form SLT compiles data on Reporting Entities' or their clients' aggregate holdings and issuances of certain long-term securities (which include equity, debt, and convertible securities as well as partnership and limited liability company interests).[393] In particular, Form SLT seeks information on (i) U.S. securities held directly by foreign residents, such as interests issued by a domestic investment fund to a foreign investor and (ii) foreign securities held directly by U.S.-resident "end-investors," such as a domestic investment fund's interest in a foreign investment fund (like a U.S. feeder of a foreign master fund) or in a foreign portfolio company.

If a U.S. adviser meets the Form SLT reporting threshold, the adviser will report on behalf of all of its domestic affiliates. Foreign managers with U.S. funds are treated differently. They report only for each U.S. fund that meets the reporting threshold on an unconsolidated basis. The calculation rules for determining

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[389] For more details on this New AML Rule, *see* Mayer Brown Legal Update, Third Time Was the Charm: FinCEN Finalizes Anti-Money Laundering Compliance Requirements Proposed for Certain Investment Advisers (Sep. 9, 2024); *see also* Mayer Brown Legal Update, SEC and FinCEN Propose Customer Identification Program Requirements for Certain Investment Advisers (May 29, 2024) for additional discussion of FinCEN's efforts to update AML requirements.

[390] The Forms were authorized by the International Investment and Trade in Services Survey Act.

[391] Certain transactions, known as "direct investment relationships" are excluded from the TIC reporting system and are instead reported separately on Form BE to the U.S. Department of Commerce's Bureau of Economic Analysis rather than to Treasury. In general, a direct investment relationship is created by owning, directly or indirectly, 10% or more of an issuer's equity voting securities. For example, investments by a manager directly into a master or feeder fund are not reportable on Forms SLT, SHC, or S because they are always considered a direct investment; whereas, investments by a feeder fund into a master fund are not.

[392] Reports are based on calendar month end data and must be filed on the 23rd of the following month for every month of that calendar year, regardless of whether the threshold is met in those months.

[393] Long-term securities are defined as those with either no stated maturity or an original term-to-maturity in excess of a year.

the reporting threshold are very complex. Some assets will satisfy more than one definition and may be double-counted.

Foreign securities owned by a domestic fund but held by a U.S.-resident custodian (or part of its sub-custodian network), including a prime broker, are reportable only by the custodian and do not count toward the $1 billion threshold of the domestic fund. Similarly, a domestic fund does not report securities issued to foreign investors where such securities are held by a U.S.-resident custodian.

2. Form SHC

Form SHC, for U.S. Ownership of Foreign Securities, is a survey held once every five years that requires reporting by U.S. persons who own foreign securities and or who invest in foreign securities on behalf of other U.S. persons, such as investment managers/fund sponsors. The last survey was required to be submitted on March 4, 2022. The next filing will be due March 2027. Reportable foreign securities include equities (excluding direct investments), long and short-term debt securities, and selected money market instruments. A U.S. investment manager will report its own foreign holdings and those of its U.S. clients including U.S. investment funds and separately managed accounts. Form SHC does not collect data on foreign residents' holdings. Securities held by US custodians, which are not reportable on Form SLT, are reportable on Form SHC, but in summary fashion. Form SHC consists of 3 schedules: (1) Schedule 1 – issuer information; (2) Schedule 2 – information about the holdings of foreign securities whose safekeeping the investment manager has entrusted directly to foreign-resident custodians or U.S.-resident or foreign-resident central securities depositories if such foreign securities have a the total fair value over the $200 million threshold (aggregated over all accounts); and (3) Schedule 3 – information about holdings of foreign securities held by US custodians if such holdings are over the $200 million threshold (aggregated over all accounts).

3. Form S

Form S, for Purchases and Sales of Long-Term Securities by Foreigners, is a transaction report that requires certain U.S. entities to report to the Federal Reserve Bank their monthly purchases and sales of long-term (both U.S. and foreign) securities in transactions entered into directly with foreign residents. For example, an issuance or redemption of an interest in a domestic investment fund involving a foreign investor, or investment or redemption by a domestic investment feeder fund involving an offshore fund. Direct investments are excluded. Reportable transactions by a foreign agent acting on behalf of U.S. entities must also be reported. The Form S threshold is reportable transactions of $50 million or more during a reporting month. If reportable transactions (purchases or sales) meet or exceed the threshold in any month, a report is required for each remaining month in the calendar year,[394] regardless of whether the threshold is met in subsequent months. However, Form S is filed by the entity that actually places a long-term foreign security order (generally, the US broker or dealer placing the trade). Investment managers must report only if they place trades directly with foreign broker-dealers or enter transactions for a domestic feeder with a foreign master fund. U.S.-resident entities that provide only custodial or settlement functions are not intermediaries for purposes of Form S.

[394] Form S must be filed by the 15th day of the month following the month in which the reporting threshold was met, and for all subsequent months in that calendar year, regardless of whether the threshold is met in those months.

4. Form B

Form B is a set of seven reports for Financial Institutions of Liabilities to, and Claims on, Foreign Residents by U.S. Residents, and requires certain U.S. entities to report to the Federal Reserve Bank based on the cross-border claims and liabilities of themselves and their clients. The filing thresholds, frequency, and content of the reports varies among the seven reports, which are briefly summarized as follows:

- Form BC is a monthly report concerning the reporter's own U.S. dollar-denominated *claims* on foreign residents. For example, management fees owed by non-U.S. clients to U.S. managers or U.S. dollars deposited in foreign banks. The filing threshold for Form BC is reportable claims of $50 million in total or $25 million with respect to any individual country.

- Form BL-1 is a monthly report concerning the reporter's own U.S. dollar-denominated *liabilities* to foreign residents. For example, fees owed by a manager to a non-U.S. service provider or affiliate. The filing threshold for Form BL-1 is reportable liabilities of $50 million in total or $25 million with respect to any individual country.

- Form BL-2 is a monthly report concerning the reporter's U.S. customers' U.S. dollar-denominated *liabilities* to foreign residents. For example, accrued fees owed by a U.S. client to a non-U.S. service provider or U.S.-dollar denominated margin or other debt owed to a foreign broker or bank. The filing threshold for Form BL-2 is reportable liabilities of $50 million in total or $25 million with respect to any individual country.

- Form BQ-1 is a quarterly report concerning the reporter's U.S. customers' U.S. dollar-denominated *claims* on foreign residents. For example, U.S. clients' holdings of U.S. dollar-denominated commercial paper of non-U.S. issuers. The filing threshold for Form BQ-1 is reportable claims of $50 million in total or $25 million with respect to any individual country.

- Form BQ-2, Part 1 is a quarterly report concerning the reporter's foreign currency *liabilities and claims*, and U.S. customers' foreign currency *claims* with foreign residents. For example, non-dollar denominated management fees owed by foreign clients to the manager or non-dollar denominated deposits held in foreign banks. The filing threshold for Form BQ-2, Part 1 is reportable claims/liabilities of $50 million in total, or $25 million with respect to any individual country.

- Form BQ-2, Part 2 is a quarterly report concerning the reporter's U.S. customers' foreign currency *liabilities* to foreign residents. For example, accrued non-dollar denominated fees owed by a U.S. client to a non-U.S. service provider. The filing threshold for Form BQ-2, Part 2 is reportable liabilities of $50 million in total with no limit with respect to individual countries.

- Form BQ-3 is a quarterly report concerning the maturity schedule for selected liabilities and claims of U.S.-resident financial institution's to foreign residents. The filing threshold for Form BQ-3 is reportable claims/liabilities of $4 billion in total with no limit with respect to individual countries.

C. Federal Privacy Rules

1. Regulation S-P: Privacy of Consumer Financial Information

The Gramm-Leach-Bliley Act required several federal agencies to, among other things, issue rules that impose notice requirements and restrictions on financial institutions' ability to disclose consumers'

nonpublic personal information and that establish appropriate standards for the protection of customer information.[395] On June 22, 2000, the SEC adopted Regulation S-P, which generally requires SEC-registered advisers[396] and (registered or unregistered) broker-dealers and investment companies (i) disclose their information gathering and sharing practices to their customers at the time a customer relationship is established by delivering a privacy notice, and (ii) to adopt policies and procedures to safeguard customer information and records (i.e., insuring security and confidentiality, guarding against threats to the information, and preventing unauthorized access to customer information).[397] The type of information covered by Regulation S-P includes nonpublic "personally identifiable information" ("PII"), which could include information that a natural person advisory client (known as a "customer") provides to an adviser to obtain a financial product or service, as well as information that the adviser otherwise obtained about the customer in connection with providing a financial product or service to that customer. Regulation S-P violations have been the subject of SEC enforcement actions.[398]

Should the adviser decide to disclose this nonpublic personal information to a nonaffiliated third party, then the adviser will need to include opt-out rights in the privacy notice provided to customers.[399] Advisers must provide their advisory clients with an initial and annual "privacy notices." Such notices must set forth, among other things, the following items:

- the categories of nonpublic personal information that the adviser collects and discloses (e.g., information from the consumer, from a consumer-reporting agency, and about the consumer's transactions);

- the categories of affiliates and nonaffiliated third parties (e.g., financial service providers or nonfinancial companies) to whom such information is disclosed;

- the right to opt out from the disclosure of the nonpublic personal information to nonaffiliated third parties; and

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[395] *See* Privacy of Consumer Financial Information (Regulation S-P), Release Nos. 34-42974, IC-24543, IA-1883 (Jun. 29, 2000) [hereinafter Regulation S-P Adopting Release]; 17 CFR Part 248; *see also* Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999).

[396] Under the Gramm-Leach-Bliley Act, Investment advisers registered with the States are regulated by the Federal Trade Commission. *See* Regulation S-P Adopting Release, n.3.

[397] *See* Regulation S-P Adopting Release, n.12.

[398] In 2015, and for the first time, the SEC charged an adviser with violating Regulation S-P by failing to adopt written policies and procedures to protect its clients' PII, after a third-party server that maintained the adviser's clients' PII was hacked. At the time of the hack, the clients' PII was not encrypted and the adviser did not have written policies and procedures as required by Regulation S-P. *In re* R.T. Jones Capital Equities Mgmt., Inc., Release No. IA-4204 (Sep. 22, 2015). In 2016, the SEC settled with a dually registered adviser and broker-dealer for Regulation S-P violations after an employee of the firm, who had taken customer account data home, was hacked and the stolen data was sold online. The SEC found that the firm had violated Regulation S-P, because its policies and procedures did not: (a) restrict employee access only to that confidential customer information for which the employee had a legitimate business need; (b) require testing of the effectiveness of the firm's access restrictions; and (c) require ongoing monitoring of employee access to and use of the firm's database. *In re* Morgan Stanley Smith Barney LLC, Release No. IA-4415 (Jun. 8, 2016).

[399] The SEC and the other federal financial regulators created a model privacy notice for financial institutions (including registered investment advisers and broker-dealers) to provide to their customers. 74 Fed. Reg. 62890 (Dec. 1, 2009).

- the adviser's policies and procedures with respect to maintaining the confidentiality and security of such information.

Advisers must also provide their advisory clients with an opt out notice, if the adviser reserves the right to disclose clients' nonpublic personal information to nonaffiliated third parties, but that advisory clients can opt out of these third party disclosures under Reg S-P. This opt out notice may be combined with the initial notice. Furthermore, SEC staff allows advisers to include the initial and annual privacy notices in other documents, such as the Form ADV, adviser's brochure, annual report, and/or prospectus, provided that the privacy notice is "clear and conspicuous" and is "distinct from and not hidden in other information."[400]

Advisers cannot disclose personal nonpublic information to nonaffiliated third parties, unless they have sent their advisory clients an initial notice and an opt out notice and have given the client a "reasonable opportunity" to opt out. Advisers should also be aware that there are limits on the reuse or nonpublic personal information provided to third party service providers or others under the exceptions in Reg S-P.[401]

On May 15, 2024, the SEC announced the adoption of amendments to Regulation S-P (the "Amendments") that broadened the scope of information covered by Regulation S-P's reporting requirements. The Amendments require broker-dealers, investment companies, SEC-registered investment advisers, funding portals, and transfer agents registered with the SEC or another appropriate regulatory agency as defined in Section 3(a)(34)(B) of the Exchange Act "Covered Institutions" ("transfer agents," and collectively with the other institution types, "Covered Institutions") to (1) adopt an incident response program to address unauthorized access to or use of "customer information"[402] and (2) notify affected individuals whose "sensitive customer information" [403] was, or is reasonably likely to have been, accessed or used without authorization.[404] Compliance with the Amendments is required within 18 months after June 3, 2024 and for larger entities and 24 months after June 3, 2024 for smaller entities.[405]

The Incident Response Program. The incident response program must include policies and procedures to:

- assess the nature and scope of any incident involving unauthorized access to or use of customer information and identify the customer information systems and types of customer information that may have been accessed or used without authorization;

- take appropriate steps to contain and control the incident to prevent further unauthorized access to or use of customer information;

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[400] SEC, Staff Responses to Questions about Regulation S-P: Question 5 (Jan. 23, 2003).

[401] 17 CFR § 248.14 & 248.15.

[402] The Amendments define the term "customer information systems" to mean the information resources owned or used by a Covered Institution, including physical or virtual infrastructure controlled by such information resources, or components thereof, organized for the collection, processing, maintenance, use, sharing, dissemination, or disposition of customer information to maintain or support the Covered Institution's operations. *See* Regulation 17 CFR § 248.30(a)(3).

[403] The term "sensitive customer information" means any component of customer information alone or in conjunction with any other information, the compromise of which could create a reasonably likely risk of substantial harm or inconvenience to an individual identified with the information. 17 CFR § 248.30(a)(9)(i).

[404] *See* Press Release, SEC, SEC Adopts Rule Amendments to Regulation S-P to Enhance Protection of Customer Information (May 15, 2024). *See also*, Mayer Brown Legal Update, SEC Adopts Amendments to Regulation S-P (May 20, 2025).

[405] 89 Fed. Reg. 47688, 47723-47725 (Jun. 3, 2024).

- notify each affected individual whose sensitive customer information was, or is reasonably likely to have been, accessed or used without authorization in accordance with the customer notification requirements discussed below, unless the Covered Institution determines, after a reasonable investigation of the facts and circumstances of the incident of unauthorized access to or use of sensitive customer information, that the sensitive customer information has not been, and is not reasonably likely to be, used in a manner that would result in substantial harm or inconvenience; and[406]

- Covered Institutions must provide any required customer notices to affected individuals as soon as reasonably practicable, but not later than 30 calendar days, after the Covered Institution becomes aware that unauthorized access to or use of customer information has, or is reasonably likely to have, occurred.[407]

The Amendments require that Covered Institutions' incident response programs include the establishment, maintenance, and enforcement of written policies and procedures reasonably designed to require oversight, including through due diligence and monitoring of "service providers," including to ensure that affected individuals receive any required notices. Specifically, the policies and procedures must be reasonably designed to ensure service providers take appropriate measures to: (1) Protect against unauthorized access to or use of customer information and (2) Provide notification to the Covered Institution as soon as possible, but no later than 72 hours after becoming aware of a breach in security has occurred resulting in unauthorized access to a customer information system maintained by the service provider. Upon receipt of such notification by the service provider, the Covered Institution must initiate its incident response program. Covered Institutions are permitted, as part of their incident response programs, to enter into a written agreement with a service provider to notify affected individuals on the Covered Institution's behalf. However, Covered Institutions retain the obligation to ensure that affected individuals are notified in accordance the notice requirements under Regulation S-P, as amended, even if such services are contracted to a service provider.

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[406] As defined under the Amendments, the term "customer information" means, for any Covered Institution other than a transfer agent, any record containing nonpublic personal information (as defined in 17 CFR § 248.3(t)) about a customer of a financial institution, whether in paper, electronic or other form, that is in the possession of a Covered Institution or that is handled or maintained by the Covered Institution or on its behalf regardless of whether such information pertains to (a) individuals with whom the Covered Institution has a customer relationship or (b) to the customers of other financial institutions where such information has been provided to the Covered Institution. For purposes of the Amendments, the term "customer" has the same meaning as in 17 CFR § 248.3(j) unless the Covered Institution is a transfer agent. For transfer agents, the term "customer" means any natural person who is a securityholder of an issuer for which the transfer agent acts or has acted as a transfer agent.

The Amendments provide examples of what could constitute sensitive customer information, including information that can be used alone to authenticate an individual's identity, such as a Social Security number, a driver's license or identification number, alien registration number, government passport number, employer or taxpayer identification number, biometric records, a unique electronic identification number, address, or routing code, or telecommunication identifying information or access device. The Amendments also provide examples of customer identifying an individual or individual's account, including a name or online username that could be used in combination with the foregoing, or other authenticating information, such as a partial Social Security number, access code, or mother's maiden name. Importantly, while the incident response program is generally required to address incidents involving any form of customer information, notification under the Amendments is only required when there has been unauthorized access to or use of sensitive customer information, a subset of customer information. As such, the incident response program's assessment and containment and control components cover a broader scope of information than the notification requirements.

[407] The Amendments permit Covered Institutions to delay providing required notices only after the SEC receives a written request from the U.S. Attorney General that such notices pose a substantial risk to national security or public safety. In practice, delay under the exception is likely to be rare. *See* Regulation 17 CFR § 248.30(a)(4)(iii).

The Notification Requirements. Notifications provided to affected individuals discussed above are substantial, with several pieces of required information to be provided by a covered institution.[408]

The Amendments permit Covered Institutions to include additional information, but do not permit omission of the prescribed information. Covered Institutions must ensure that required notices are transmitted by a means designed to ensure that affected individuals can reasonably be expected to receive actual notice in writing. These written notifications may be provided electronically if certain conditions are met, such as if the customer has agreed to receive information electronically, and subject to other applicable law (e.g., state-level notification requirements).[409]

If an incident of unauthorized access to or use of customer information has or is reasonably likely to have occurred, but the Covered Institution is unable to identify which specific individuals' sensitive customer information has been accessed or used without authorization, such Covered Institution must provide notice to all individuals whose sensitive customer information resides in the customer information system that was, or was reasonably likely to have been, accessed or used without authorization. Notwithstanding the foregoing, if the Covered Institution reasonably determines that a specific individual's sensitive customer information that resides in the customer information system was not accessed or used without authorization, the Covered Institution is not required to provide notice to that individual.[410]

2. Regulation S-AM: Limitations on Affiliate Marketing

The Fair and Accurate Credit Transactions Act of 2003 amended the Fair Credit Reporting Act of 1970 ("FCRA") to require several federal agencies to issue rules limiting persons' use of certain consumer information received from their affiliate(s) to solicit consumers.[411] On August 4, 2009, the SEC adopted

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[408] The notices must include "(A) Describe in general terms the incident and the type of sensitive customer information that was or is reasonably believed to have been accessed or used without authorization; (B) Include, if the information is reasonably possible to determine at the time the notice is provided, any of the following: the date of the incident, the estimated date of the incident, or the date range within which the incident occurred; (C) Include contact information sufficient to permit an affected individual to contact the covered institution to inquire about the incident, including the following: a telephone number (which should be a toll-free number if available), an email address or equivalent method or means, a postal address, and the name of a specific office to contact for further information and assistance; (D) If the individual has an account with the covered institution, recommend that the customer review account statements and immediately report any suspicious activity to the covered institution; (E) Explain what a fraud alert is and how an individual may place a fraud alert in the individual's credit reports to put the individual's creditors on notice that the individual may be a victim of fraud, including identity theft; (F) Recommend that the individual periodically obtain credit reports from each nationwide credit reporting company and that the individual have information relating to fraudulent transactions deleted; (G) Explain how the individual may obtain a credit report free of charge; and (H) Include information about the availability of online guidance from the Federal Trade Commission and usa.gov regarding steps an individual can take to protect against identity theft, a statement encouraging the individual to report any incidents of identity theft to the Federal Trade Commission, and include the Federal Trade Commission's website address where individuals may obtain government information about identity theft and report suspected incidents of identity theft." *See* Regulation 17 CFR § 248.30(a)(4)(iv).

[409] As stated above, there is no obligation to notify customers if a Covered Institution has determined, after a reasonable investigation of the facts and circumstances of the incident of unauthorized access to or use of sensitive customer information that occurred at such Covered Institution or one of its service providers that is not itself a Covered Institution, that sensitive customer information has not been, and is not reasonably likely to be, used in a manner that would result in substantial harm or inconvenience. This risk of harm threshold will enable Covered Institutions to avoid providing notification to customers when there is unauthorized access to their sensitive customer information but not harm is reasonably likely to occur. *See* Regulation 17 CFR § 248.30(a)(4).

[410] *See* Regulation 17 CFR § 248.30(a)(4)(ii).

[411] *See* Fair and Accurate Credit Transactions Act of 2003, Pub. L. No. 108-159, 117 Stat. 1952 (2003).

Regulation S-AM.[412] Regulation S-AM conditionally prohibits broker-dealers, investment companies, and registered advisers and transfer agents from *using* certain "eligibility information" to make "marketing solicitations" to a consumer, when that "eligibility information" was received from an affiliate. "Eligibility information" includes information about a consumer's credit worthiness, credit standing, credit capacity, character, general reputation, personal characteristics, or mode of living.[413] "Marketing solicitation" includes a telemarketing call, direct mail, or e-mail. Where the following conditions are met, then Regulation S-AM will not prohibit an adviser from using "eligibility information" to solicit a consumer:

- the consumer has received clear and conspicuous notice of the potential marketing use of the information (this notice can be combined with the notice required by Regulation S-P);
- the consumer has been provided a reasonable opportunity and a simple method to respond to and opt out from receiving the "marketing solicitation"; and
- the consumer did not opt out.

Regulation S-AM has exceptions for: (1) general public solicitations (e.g., radio and television advertisements, and public websites); (2) solicitations by a person (e.g., an adviser) who has a pre-existing business relationship with a consumer; (3) the use of eligibility information to perform services for an affiliate, provided that the consumer has not already elected to opt out; (4) marketing solicitations sent in response to a consumer's communication regarding a person's (e.g., adviser's) product or services or in response to the consumer's authorization or request to receive such solicitations; and (5) the use of eligibility information to facilitate communications to individual participants in an employee benefit plan.

3. Regulation S-ID: Identity Theft Red Flags

The FCRA required several federal agencies to, among other things, issue rules regarding the detection, prevention, and mitigation of identity theft (commonly referred to as the "identity theft red flag" rules). Dodd-Frank Title X, Section 1088(a)(8) and (10), amended FCRA Section 615(e) by adding the SEC and the CFTC ("Commissions") to the list of agencies required to prescribe and enforce identity theft red flags rules and guidelines and card issuer rules. On April 10, 2013, the Commissions adopted joint rules. New SEC Regulation S-ID is substantially identical to existing identity theft rules and applies to registered investment advisers, registered investment companies, and registered broker-dealers if the entity is a "financial institution" or a "creditor" that maintains a "covered account," each as defined.[414]

"Financial institution" includes, among others, any person that "directly or indirectly, holds a transaction account (as defined in Section 19(b) of the Federal Reserve Act) belonging to a consumer." "Consumers" are individuals only and a "transaction account" is an "account on which the . . . account holder is permitted to make withdrawals by negotiable or transferable instrument, payment orders of withdrawal, telephone transfers, or other similar items for the purpose of making payments or transfers to third persons or others." A "covered account" includes "(i) an account that a financial institution or creditor offers or maintains, primarily for personal, family, or household purposes, that involves or is designed to permit multiple

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[412] *See* Regulation S-AM: Limitations on Affiliate Marketing, Release Nos. 34-60423, IC-28842, IA-2911 (Aug. 4, 2009) [hereinafter Regulation S-AM Adopting Release].

[413] Regulation S-AM Adopting Release, at 23 n.70.

[414] *See* Identity Theft Red Flags Rules, Release Nos. 34-69359, IC-30456, IA-3582 (Apr. 10, 2013).

payments or transactions and (ii) any other account that the financial institution or creditor offers or maintains for which there is a reasonably foreseeable risk to customers or to the safety and soundness of the financial institution or creditor from identity theft, including financial, operational, compliance, reputation, or litigation risks."

Advisers subject to Reg. S-ID must maintain a program designed to detect, prevent, and mitigate identity theft in connection with covered accounts appropriate for the size and complexity of the entity, not a "one size fits all" solution. The program must consist of reasonable policies and procedures which: (1) identifies relevant red flags for the covered accounts that the financial institution or creditor offers or maintains and incorporates them into the program; (2) detects incorporated red flags; (3) responds appropriately to any red flags detected; and (4) periodically updates the program (including relevant red flags), to reflect changes in risks to customers and to the safety and soundness of the financial institution or creditor from identity theft.

In 2018, the SEC brought its first enforcement action brought against a dually registered investment adviser/broker-dealer for violation of the identity theft prevention program requirements in Regulation S-ID (the action also involved alleged violations of Regulation S-P). In the action, the SEC alleged that the firm failed to adopt written policies and procedures reasonably designed to protect customer records and information prior to a cybersecurity breach that resulted in a third-party cyber intruder obtaining certain personal information of approximately 5,600 clients.[415]

[415] *See In re* Voya Financial Advisors, Inc., Release No. IA-5048 (Sep. 26, 2018). According to the order, cyber intruders impersonated contractors of an adviser over a six-day period in 2016 by calling the adviser's support line and requesting password resets for such contractors' passwords. The intruders subsequently used the reset passwords to gain access to client personal information, which was utilized to create new online customer profiles and obtain unauthorized access to account documents for three customers. The SEC alleged that the dual registrant's failure to terminate the intruders' access stemmed from weaknesses in its cybersecurity procedures, particularly its procedures governing system access by the firm's independent contractors, who make up a sizable portion of the firm's workforce.

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