Slew of Recent SEC Enforcement Actions: Guidance for Registered Investment Advisers

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On September 5, the U.S. Securities and Exchange Commission (SEC) announced enforcement actions against five investment advisers for violating Rule 206(4)-2 (the Custody Rule) and Rule 204-1(a) (the ADV Reporting Rule) of the Investment Advisers Act of 1940, as amended (the Advisers Act). Less than a week later, on September 11, the SEC announced additional enforcement actions against nine registered investment advisers for violating Rule 206(4)-1 (the Marketing Rule). Then, on September 13, the SEC released an order against an adviser for failure to file Form 13F pursuant to Section 13(f)(1) of the Securities Exchange Act of 1934 (Exchange Act). Most recently, on September 28, the SEC announced another set of Custody Rule-related enforcement actions against four investment advisers.

Summary of the Proceedings

Custody Rule-Related Actions

In its September 5 announcement, the SEC disclosed that it had settled charges with a handful of registered investment advisers for violating the Custody Rule and the ADV Reporting Rule for (i) failing to maintain client funds or securities with a qualified custodian, (ii) failing to conduct and/or timely distribute annual audited financial statements–prepared in accordance with generally accepted accounting principles (GAAP) by an independent public accountant registered with the Public Company Accounting Oversight Board (the PCAOB)–to investors in certain private funds that they advised, as well as, (iii) in certain instances, failing to promptly update Form ADV as new events regarding those audits occurred. The advisers all have agreed to settle the SEC's charges, resulting in penalties ranging from $50,000 to $225,000, totaling more than $500,000 in combined penalties.

Less than a month later, the SEC announced that it had settled charges against four investment advisers for violating the Custody Rule by failing to obtain verification by an independent public accountant of client funds and securities over which they had custody by virtue of the agreements between and among the advisers, their clients, and the clearing firms. All four of the advisers settled the charges and agreed to each pay a $100,000 penalty.

The Custody Rule requires registered investment advisers who have custody of client funds or securities to follow specific rules designed to safeguard those assets in order to avoid loss, misuse, or misappropriation of those assets. It is a violation of the rule for investment advisers to have custody[1] of client funds or securities if they fail to comply with certain requirements, discussed immediately below. An investment adviser who has custody of client funds or securities must, among other duties, (i) maintain client assets with a qualified custodian, (ii) notify the client in writing of accounts opened by the adviser at a qualified custodian on the client's behalf, (iii) have a reasonable basis for believing that the qualified custodian sends account statements at least quarterly to clients, and (iv) obtain verification of client funds and securities by actual examination each calendar year by an independent public accountant at a time chosen by the accountant without prior notice or announcement to the adviser. See Rule 206(4)-2(a).

For certain pooled investment vehicles (including private funds), the Custody Rule provides that an investment adviser will be deemed to have complied with the independent verification requirement prescribed by the Custody Rule, and therefore is not required to satisfy the account notification and account statements delivery requirements, if the private fund is subject to audit at least annually and distributes the private fund's audited financial statements (prepared by an independent accountant registered with and regulated by the PCAOB in accordance with GAAP) within 120 days of the private fund's fiscal year-end or within 180 days for a fund of funds and longer for a fund of

[1] An investment adviser has custody of client funds or securities if it holds, directly or indirectly, client funds or securities or if it has the ability to obtain possession of those assets. *See* Advisers Act Rule 206(4)-2(d)(2).

fund of funds (the Audited Financials Alternative). Additionally, certain pooled investment vehicles (including private funds) are not required to comply with the qualified custodian requirement for certain privately offered securities so long as such private fund otherwise satisfies the conditions of the Audited Financial Alternative (the Privately Offered Securities Exception). Separately, the ADV Reporting Rule requires a registered investment adviser to amend its Form ADV at least annually, and more frequently as required by the instructions to Form ADV, including with respect to the status of the audited financial statements of its private fund clients.[2]

In the September 5 enforcement cases, each of the advisers purported to rely upon the Audited Financials Alternative and (1) failed to maintain client funds or securities with a qualified custodian, (2) failed to timely conduct and/or distribute annual audited financial statements prepared by an independent account registered with and regulated by the PCAOB in accordance with GAAP to investors in one or more private funds, or (3) failed to do both (1) and (2), in each instance with respect to one or more private funds advised by the adviser. Additionally, in certain instances, the advisers also failed to promptly update or revise their Form ADVs to properly describe the status of the annual audited financial statements with respect to one or more of their advised private funds.

In the September 28 enforcement cases, each adviser used, as part of its customer agreements, a form agreement required by the clearing agent that served as a margin account agreement. These agreements contained language, required by the clearing agent, that permitted the clearing agent to accept, without inquiry or investigation, any instructions given by the adviser with respect to these client accounts. The orders provide that because of the rights granted by the advisers to the clearing agent under the customer agreement, the advisers had authority with respect to client funds and securities in these accounts that amounted to custody under the Custody Rule.

Among other things, as noted above, the Custody Rule requires investment advisers who have custody of client funds or securities and are not relying on the Audited Financials Alternative to have independent public accountants conduct a verification of those client funds and securities by actual examination at least once each calendar year by an independent accountant at a time chosen by the accountant without prior notice (a so-called annual surprise examination). By failing to have an annual surprise examination of these client funds and securities for which it had custody, the advisers identified in the September 28 enforcement cases were found to have willfully violated the Custody Rule.

Gurbir S. Grewal, Director of the SEC's Enforcement Division, emphasized the significance of complying with the Custody Rule, stressing the risks that noncompliance poses to the safety and security of client assets. These enforcement actions underscore the SEC's commitment to holding private fund advisers accountable for failures to take the required measures to protect client assets under the Custody Rule, to promptly amend and disclose information in their Form ADV concerning private fund audits, and to timely distribute audited financial statements. Notably, the September 5 set of cases was the second set of cases that the SEC has brought in recent years as part of a targeted sweep concerning combined violations of the Custody Rule and Form ADV requirements. Nine private fund advisers were charged for similar failures in September 2022.[3]

Marketing Rule-Related Actions

On September 9, the SEC also announced settlements against nine registered investment advisers who were alleged to have violated the Marketing Rule by advertising hypothetical performance on their websites without adopting and implementing policies and procedures reasonably designed to ensure that the hypothetical performance was relevant to the likely financial situation and investment objectives of their intended audience. Each of the firms involved, with regulatory assets under management ranging from $42 million to $1.28 billion, agreed to settle charges, with penalties totaling $850,000.

The Marketing Rule, which was amended effective May 4, 2021, with a compliance date of November 4, 2022, introduced substantial changes to the regulatory framework governing investment adviser advertising.[4] Under the Marketing Rule, investment advisers are obligated to have policies and procedures reasonably designed to ensure that any hypothetical performance presented in advertisements is relevant to the likely financial situation and investment objectives of the intended audience. The SEC had previously expressed its view in the adopting release for the Marketing Rule[5] that advisers generally should not include hypothetical performance in advertisements directed to a mass audience or intended for general circulation because advisers would be unable to form expectations about the audience's financial situation or investment objectives, given the broad and diverse nature of mass audiences.

The SEC's investigation revealed that all the charged firms advertised hypothetical performance to mass audiences on their websites without having the required policies and procedures in place.

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[2] The instructions to Form ADV can be found at https://www.sec.gov/about/forms/formadv-instructions.pdf.
[3] *See* https://www.sec.gov/news/press-release/2022-156.
[4] *See* our client alert at https://www.lowenstein.com/news-insights/publications/client-alerts/sec-modernizes-investment-adviser-and-solicitor-marketing-rules-investment-management.
[5] https://www.sec.gov/news/press-release/2023-173.

Additionally, two of the advisers failed to maintain copies of their advertisements, violating Rule 204(a)(11) of the Advisers Act, which requires investment advisers to maintain copies of all disseminated advertisements.

Rule 13F-Related Action

On September 9, the SEC announced a settlement against a registered investment adviser who failed to file Forms 13F for several years, resulting in a penalty of $150,000.

Section 13(f)(1) of the Exchange Act and Rule 13f-1 thereunder require that institutional investment advisers file Form 13F with the SEC on a quarterly basis if they exercise investment discretion over at least $100 million in certain securities that are traded on a national securities exchange or on the automated quotation system of a registered securities association. An investment adviser is deemed to exercise discretion over all accounts for which any person or entity under the control of the investment adviser exercises investment discretion. Each Form 13F filed with the commission is available to the public for review.

From December 2016 through March 2022, the charged adviser had investment discretion over more than $100 million of reportable securities and was therefore obligated to file a quarterly Form 13F beginning in February 2017. However, the adviser failed to file Form 13F until April 2022.

As a result of the adviser's failure to file Forms 13F from the quarter ending December 31, 2016, through the quarter ending December 31, 2021, the SEC found that the adviser willfully violated Section 13(f)(1) of the Exchange Act and Rule 13f-1 thereunder.

Implications

The SEC's enforcement actions highlight several crucial lessons for investment advisers.

Custody Rule and ADV Reporting Rule:

- Custody Rule Compliance: Investment advisers must diligently adhere to the requirements of the Custody Rule to ensure the safety and security of client funds and securities by ensuring timely distribution of audited financials to private fund investors when relying on the Custody Rule Audited Financials Alternative.
- ADV Reporting Rule Compliance: Advisers should promptly and accurately update their Form ADV disclosures to appropriately reflect changes in the status of private fund audited financial statements.

Marketing Rule:

- Robust Policies and Procedures: Investment advisers must establish and maintain comprehensive policies and procedures that align with the modernized Marketing Rule requirements. Among other things, advisers must be able to demonstrate that hypothetical investment performance shown in advertisements is relevant in light of the financial situation and investment objectives of the intended audience.
- Record-Keeping: Advisers should be diligent in maintaining copies of their advertisements as mandated by the rule.

Form 13F Compliance:

- Advisers should ensure timely filing of Form 13F as soon as they meet the requirement of $100 million in 13F securities over which they exercise investment discretion.

These recent enforcement actions, announced in quick succession and, in the case of the new Marketing Rule violations, shortly after the compliance date, demonstrate the SEC's focus on enforcement in these areas consistent with its stated 2023 Enforcement Priorities.[6] The numerous actions are not particularly complex or punitive, providing for generally uniform settlements and relatively low penalty amounts. This is indicative of the SEC's seemingly now-prevailing approach to enforcement.

Based on these actions and the vigilant posture of the SEC in recent years, investment advisers should expect ongoing regulatory scrutiny in these areas, and we recommend that investment advisers conduct a thorough review of their compliance policies and procedures related to each of the rules that were the subjects of these enforcement actions.

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[6] *See* https://www.lowenstein.com/news-insights/publications/client-alerts/sec-releases-2023-examination-priorities-for-registered-investment-advisers-and-broker-dealers-investment-management.

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