Davis Polk

Investment Management & Funds Regulatory Update - June 2026

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In this issue, we discuss a Risk Alert issued by the SEC's Division of Examinations regarding conflicts of interest involving investment advisers, and a recent enforcement action against an investment adviser involving an alleged cherry-picking scheme, among other topics.

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Rules and Regulations

Increased "qualified client" thresholds for performance fees became effective June 2026

The SEC's order (Order) approving an increase in the "qualified client" thresholds in Rule 205-3(d)(1)(i) and Rule 205-3(d)(1)(ii)(A) under the Advisers Act became effective on June 29, 2026. As stated in the Order, taking into the account the effects of inflation, the dollar amount of the assets-under-management test in Rule 205-3(d)(1)(i) will increase from $1,100,000 to $1,400,000, and the dollar amount of the net worth test in Rule 205-3(d)(1)(ii)(A) will increase from

$2,200,000 to $2,700,000. The Order clarified that to the extent contractual relationships are entered into prior to the effective date, such adjusted dollar amounts generally would not apply retroactively to such contractual relationships, subject to the transition provisions incorporated in Rule 205-3.

Department of Labor issues proposed rule aiming to expand access to alternative investments by retirement investors

The Department of Labor released its highly anticipated proposed rule that aims to expand access to alternative investments by 401(k) and other individual account plans. Although a step in the right direction, the proposed rule should be modified to facilitate the inclusion of more than just asset allocation funds in plan menus. Please see our recent client update on this topic, in which we discuss modifications that would expand access to alternative investments through other fund options and how the SEC can support this effort.

Industry Update

SEC issues observations on economic conflicts of interest for investment advisers

The SEC's Division of Examinations (the Division) issued a Risk Alert (Risk Alert) on June 9, 2026 detailing examination observations related to investment advisers' obligations arising from economic conflicts of interest. The Risk Alert catalogs a wide range of deficiencies identified during recent examinations, spanning inadequate disclosures, fee billing errors, and compliance program gaps, and serves as a reminder that the Division views economic conflicts as a persistent, high-priority area of examination focus.

Background

As fiduciaries, investment advisers are required under the Investment Advisers Act of 1940 (the Advisers Act) to act in their clients' best interests and to eliminate, or fully and fairly disclose, all conflicts of interest that might, consciously or unconsciously, cause an adviser to render advice that is not disinterested. This fiduciary standard applies to economic conflicts across all facets of an adviser's business. Economic conflicts of interest have been a Division examination priority every year since 2021. The Risk Alert follows earlier staff publications in this area and reflects the Division's continued view that advisers are not fully meeting their fiduciary obligations in practice. The Risk Alert signals where Division staff will focus their attention and where referrals to the Division of Enforcement may follow.

Overview of examination findings

The Division organized its findings into five areas: (a) conflicts associated with cash management recommendations; (b) conflicts associated with other revenue opportunities; (c) Form ADV disclosure deficiencies; (d) fees that deviate from advisory agreements and disclosures; and (e) compliance program weaknesses. We summarize each in turn.

A. Cash management recommendations

A recurring theme in the Risk Alert involves advisers that recommended programs through which clients' uninvested cash was automatically swept into interest-bearing accounts, including some held at affiliates of the adviser. Where advisers received revenue in exchange for such recommendations, the Division found that a conflict of interest existed requiring full and fair disclosure to enable clients to provide informed consent. The Division identified the following deficiencies:

- *Revenue sharing with custodians*. Advisers omitted material information about revenue sharing arrangements with clearing broker-dealers and custodians, including failing to disclose that they received compensation based on the amount of client cash held at particular custodians creating an incentive to recommend sweep vehicles that maximized adviser compensation.
- *Misleading "may receive" language*. Some advisers disclosed only that they "may" receive revenue from third-party bank cash sweep programs when in fact they did receive such revenue. As the Division reaffirmed, the word "may" is inappropriate where a conflict actually exists.

- *Undisclosed fee impact*. Advisers failed to disclose that clients' cash balances were subject to the advisers' asset-based fees, or failed to disclose the impact of those fees on investment returns, including in cases where the combined effect of fees and expenses caused clients to earn negative returns on their cash positions.
- *Money market fund share class selection*. Advisers that limited cash management recommendations to higher-cost money market fund share classes participating in revenue sharing arrangements, without disclosing that lower-cost share classes of the same funds were available and that those lower-cost classes provided no revenue to the adviser, were found to have failed their disclosure obligations.

B. Other revenue opportunities

Beyond cash management, the Division identified conflicts arising from advisers' selection of mutual fund share classes and from various other economic arrangements. Where advisers—acting as, or through affiliates that were, dually registered broker-dealers—recommended share classes paying Rule 12b-1 fees rather than lower-cost share classes of the same funds available to clients, the resulting conflict was not adequately disclosed. The Division also identified deficiencies in the disclosure of the following:

- *Custodial credits.* Advisers that received credits for custodial and clearing relationships tied to client assets maintained at unaffiliated broker-dealers did not disclose the nature of those credits or the fact that the advisers would incur termination fees if they ended those clearing relationships.
- *Margin loan markups*. Advisers failed to disclose that their broker-dealer affiliates received revenue through interest rate markups on margin loans extended to advisory clients.
- *Fee markups on clearing charges*. Advisers assessed additional fees to clients beyond what was charged by clearing broker-dealers—in effect marking up the clearing brokers' fees—without adequate disclosure.

C. Form ADV Disclosure Deficiencies

The Division reviewed advisers' Part 2A brochures and identified misstatements and omissions under multiple required disclosure items:

- *Financial Industry Activities and Affiliations (Item 10)*. Advisers omitted material conflicts arising from compensation arrangements with affiliates—for example, failing to disclose that an affiliated broker-dealer was likely to indirectly benefit through revenue generated by clearing firm services performed for advised clients.
- *Brokerage Practices (Item 12)*. Advisers with revenue sharing arrangements with clearing agencies made disclosures under Item 12 that were either incomplete or internally inconsistent with other disclosures appearing elsewhere in the same brochure.

D. Fee billing inconsistent with agreements and disclosures

The Division found numerous instances in which advisers charged clients fees that were inconsistent with their advisory agreements, Form ADV disclosures, or both.

- *Fee calculations that deviated from disclosed methodologies*. Instances included: prorating advisory fees for mid-period deposits or withdrawals without contractual authority or contrary to disclosed billing methodologies; assessing asset-based fees on holdings specifically excluded from fee calculations under advisory agreements (e.g., initial cash inflows and fixed income assets); applying incorrect fee rates and failing to apply reduced rates for certain asset classes, including failures to household accounts properly for fee-rate breakpoints; and failing to rebate transaction fees that the advisory agreement expressly stated the client would not incur.
- *Fees charged for services not provided*. Advisers charged clients for wealth management and advisory services that were not actually rendered because the personnel managing the accounts had departed and the accounts were not reassigned. Staff also found advisory fees charged on inactive accounts that received no supervisory or management services, including accounts that held predominantly cash and that clients had requested in writing to close, as well as duplicative billing arising from internal asset transfers that resulted in clients being charged more than once for the same services. Advisers additionally failed in some instances to issue refunds of unearned prepaid fees upon client termination, including in cases where the client had not affirmatively submitted a written refund request.

E. Compliance program deficiencies

The Division found that many of the foregoing failures were traceable, at least in part, to inadequate written policies and procedures under Rule 206(4)-7 (the Compliance Rule). Specific deficiencies included:

- *Incomplete coverage of billing arrangements*. Written policies and procedures did not address all billing arrangements applicable to the firm's client base, such as prepaid fee arrangements, account householding for fee breakpoints, and margin on client accounts.
- *Internal inconsistency*. Policies and procedures, client disclosures, and advisory agreements contained conflicting information about the adviser's billing practices—for instance, regarding the adviser's authority to directly withdraw advisory fees from client accounts. Compliance documents also contained schedules and narratives that were difficult to reconcile, or disclosures that were overly complicated.
- *Absence of fee-billing controls*. Advisers lacked monitoring controls sufficient to verify the accuracy of fee calculations, including controls to detect manual input errors in prorated fee calculations, to confirm that rebates and refunds were issued to terminated accounts, and to prevent the continued assessment of advisory fees to clients who had terminated their relationships with the adviser.

Conclusion

The Risk Alert reflects a well-established examination priority and is both a diagnostic tool and a warning. By cataloging with specificity the disclosure failures, fee billing errors, and compliance program deficiencies it has observed across examinations, the Division outlines what examiners will look for and what enforcement referrals may follow. The Division made clear that it views economic conflicts as warranting "routine review" during adviser examinations. In practice, this means that advisers can expect that Division staff will scrutinize revenue-sharing arrangements, fee billing practices, Form ADV brochures, and compliance policies with a high degree of specificity. Investment advisers should conduct a conflict inventory, review disclosures and fee billing practices, and review existing compliance policies and procedures in light of these observations.

Litigation

SEC settles charges against investment adviser relating to alleged cherry-picking scheme of its former CIO

On April 8, 2026, the SEC issued an order (the Order) instituting and settling administrative and cease-and-desist proceedings against a registered investment adviser (the Respondent) for failing to take reasonable steps to detect and prevent an alleged cherry-picking scheme of its former co-chief investment officer (CIO).

According to the Order, the CIO was charged, in a litigated district court action brought by the SEC in November 2024, with engaging in a cherry-picking scheme from January 2021 through October 2023 (Relevant Period) by disproportionately allocating trades with net realized and unrealized first-day gains to certain favored portfolios, while allocating trades with net realized and unrealized first-day losses to other disfavored portfolios. As noted in the Order, the Respondent's Form ADV during the Relevant Period provided that its investment allocations were done in a manner the Respondent believed to be fair and equitable, and that it "maintain[ed] a variety of policies and practices designed to reduce the potential for favoritism." The Order noted that the Respondent's written compliance manual included policies and procedures requiring that the allocation of securities among participating clients be completed "no later than the end of the day on which the transaction is completed" and "be made in a fair and equitable manner."

The SEC determined that despite such policies and procedures, the majority of the CIO's trade allocations during the Relevant Period were entered after the time the relevant exchange set daily settlement prices, and given the high liquidity of the securities the CIO traded, there was often price movement between the time the CIO placed the trades and the time such trades were allocated. The SEC alleged that because of this delay, the CIO had an opportunity to review market movements before allocating trades, and that during the Relevant Period, the CIO disproportionately allocated favorable trades to certain portfolios and unfavorable trades to other portfolios. The SEC determined that certain of the Respondent's personnel were aware of the CIO's allocation practices, but despite this knowledge, the Respondent "failed to consider or assess whether market movements after [the CIO] placed his trades were a factor in [the CIO's] allocation decisions." The Order noted that the CIO was supervised by the Respondent's CEO, as well as two internal departments responsible for supervising and monitoring trading for compliance with allocation policies and guidelines. However, the SEC alleged that the Respondent "lacked consistent information necessary to understand whether market movements between [the CIO's] executions and allocations may have played a role in his decision making." Thus, according to the Order, the Respondent failed reasonably to supervise the CIO, and did not take reasonable steps to ensure that the

CIO's trading and allocation practices were consistent with the Respondent's fiduciary duties and disclosures to clients, and in compliance with the Respondent's policies and procedures.

As a result of this conduct, the SEC found that the Respondent violated the anti-fraud provisions of Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, and failed reasonably to supervise the CIO within the meaning of Section 203(e)(6) of the Advisers Act.

The Respondent consented to a cease and desist order and was ordered to pay a civil money penalty of $100 million.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

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