Davis Polk

Investment Management Regulatory Update – July 2021

July 30, 2021 | Client Update | 10-minute read

Here is our latest report on regulatory developments relating to private equity and investment management. In this issue, we discuss, among other things, recent SEC enforcement actions involving funds and investment advisers, and relevant industry and SEC updates.

Industry Update

SEC Chair Gensler remarks before the Asset Management Advisory Committee

SEC Division of Examinations Risk Alert on fixed income principal trades and cross trades

Litigation

SEC charges SPAC, sponsor, target and CEOs for misleading disclosures and inadequate due diligence

SEC commences administrative proceedings against audit firm, professionals, for alleged "widespread audit failures"

Industry update

SEC Chair Gensler remarks before the Asset Management Advisory Committee

On July 7, 2021, Securities and Exchange Commission (SEC) Chair Gary Gensler delivered prepared remarks before the Asset Management Advisory Committee. Chair Gensler's comments focused on funds that hold themselves out publicly as investing with an emphasis on sustainability, and diversity in the asset management industry.

Chair Gensler began by discussing concerns regarding funds that use marketing terms such as "green," "sustainable" and "low-carbon," ultimately creating a "huge range of what asset managers might mean by [these] certain terms…" Chair Gensler noted that he believes investors should be able to have a realistic understanding of what these terms truly mean in the context of each fund that uses them. To that end, he has asked SEC staff to "consider recommendations

Copyright 2021 Davis Polk & Wardwell LLP

about whether fund managers should disclose the criteria and underlying data they use." Chair Gensler also noted that the increased use of third-party service providers, such as those that provide sustainability-related ratings, raises questions regarding "what data underpin those assertions, whether those service providers are providing investment advice, and what advisers' responsibilities are with respect to their use of such services."

Relatedly, Chair Gensler stated that he believes updates to fund disclosures and naming conventions could bring increased transparency to the asset management industry, particularly in light of the recent focus on sustainability. A fund's name is important – as Chair Gensler stated, "[a] fund's name is one of the first pieces of information that investors see. If a fund's name suggests a certain investment focus, investors expect investment in that area." Chair Gensler touched on the naming convention requirements under the Investment Company Act of 1940, and noted that while fund naming conventions were updated in 2001, quite a bit has transpired in capital markets since then.

Chair Gensler concluded his remarks by discussing diversity and inclusion in the asset management industry. He noted that he will work with SEC staff to increase transparency, which he believes is important in improving the diversity and inclusion practices of the industry.

Commissioners Hester M. Peirce and Caroline A. Crenshaw also delivered prepared remarks at the meeting. The Commissioners predominantly discussed draft findings of the Subcommittee on Diversity and Inclusion which recommended, among other things, proposals for enhanced disclosure in SEC filings by registered advisers and funds with respect to gender and racial diversity issues, and for SEC staff review and guidance on factors to be considered by fiduciaries in selecting asset managers and pay-to-pay rules. The Commissioners also discussed draft recommendations of the ESG Subcommittee, which generally called for SEC staff guidance regarding disclosure frameworks for material ESG matters and ESG investment product descriptions. The Commissioners urged the members of the Asset Management Advisory Committee to consider carefully the recommendations.

– See Chair Gensler's remarks
– See Commissioner Peirce's remarks
– See Commissioner Crenshaw's remarks

SEC Division of Examinations Risk Alert on fixed income principal trades and cross trades

On July 21, 2021, the Division of Examinations (Division) issued a Risk Alert that highlighted common compliance issues observed by Division staff in its examination initiative focusing on registered investment advisers engaged in cross trades and/or principal trades involving fixed income securities. The Risk Alert supplements a previously published Risk Alert issued on September 4, 2019 by providing greater detail on certain compliance issues.

Staff observations and scope of examination initiative

Division staff focused its examination on three areas: compliance programs, conflicts of interest, and disclosures. According to the Risk Alert, nearly two-thirds of the examined advisers received staff-issued deficiency letters, with the vast majority of them relating to these three areas.

Compliance programs. Division staff assessed whether advisers' written policies and procedures effectively addressed principal trades and cross trades. Over half of the deficiencies the staff observed related to compliance programs, including the following examples:

– Policies and procedures were inconsistent with the advisers' practices, disclosures and/or regulatory requirements. For example, some compliance programs did not include procedures to validate that the trades effected were consistent with the advisers' disclosures or policies and procedures. As another example, some compliance programs did not include procedures to validate that appropriate disclosures to clients were made or consents received.
– Policies and procedures lacked certain considerations or guidance, leading to adviser personnel not having the necessary information to achieve compliance. For example, some policies and procedures mandated that trades be executed in the best interests of the clients but did not include what factors to consider in making these best interest determinations. As another example, some advisers contractually committed to manage clients' portfolios in compliance with ERISA, but their compliance programs did not contain policies or procedures regarding what the advisers must do to be in compliance with ERISA.
– Policies and procedures were not effectively tested. As a result, some advisers were unaware that certain trades had occurred that were not in compliance with their policies and procedures.

Copyright 2021 Davis Polk & Wardwell LLP

Conflicts of interest. Division staff assessed whether principal trades and cross trades appeared to be made in clients' best interests, rather than to further the advisers' interests. For example, the staff observed some cross trades that were not executed at independent market prices and some that were subject to undisclosed fees.

Disclosures. Division staff assessed whether the conflicts of interest related to principal trades and cross trades were fully and fairly disclosed to clients. The staff observed advisers failing to include certain relevant information in their Forms ADV, including disclosures related to conflicts of interest associated with executing cross trades.

Staff observations on ways to improve compliance

Some best practices that Division staff observed include the following:

Compliance programs. According to the Risk Alert, best practices included adopting and enforcing compliance programs that do the following:

- *Incorporate all applicable legal and regulatory requirements*.
- *Clearly define covered activities*. Division staff noted that when compliance programs possess specific and detailed definitions (e.g., when defining cross trades, including the time frame within which the transactions must occur to be considered cross trades, such as crossing on the same day or within three days of the trade date), the procedures are more likely to be followed.
- *Set standards*. Division staff observed that setting standards helps to promote compliance such as, among other things, mandating that transactions should be fair and equitable to all participating client accounts and mandating that prescribed pricing methodologies be used.
- *Conduct testing for compliance*. The Risk Alert noted that advisers with written policies and procedures were more likely to conduct internal compliance reviews. Some self-identified issues included instances where advisers did not maintain documentation or information regarding a given trade and where advisers did not provide full and fair disclosure regarding trades to clients.
- *Place conditions on the execution of principal trades or cross trades within clients' accounts*. Division staff observed that examined advisers often placed conditions on execution of trades for client accounts, such as, among other things, a requirement that the securities be purchased by or sold to another client only when there is a need and the securities meet each participating client's investment objectives; and a requirement that the trades receive best price and best execution (e.g., independent pricing from third-party brokers).

Written disclosures.

- *Provide clients with full and fair disclosure of all material facts*. Some examples observed by Division staff included, among other things: how the adviser addressed the identified conflicts of interest, any costs associated with these transactions (including a description of the pricing methodologies) and the total amount of commissions received by the adviser.
- *Provide disclosures to clients in multiple documents*. Division staff observed that examined advisers provided disclosures regarding principal and cross trading practices in multiple documents, such as the Form ADV, Part 2A; advisory agreements; separate written communications to clients; private fund offering documents, as well as in oral conversations with clients.

Conclusion

The Division encouraged advisers to review their written policies and procedures regarding principal and cross trades, including the implementation of these policies and procedures, to ensure consistency with the Investment Advisers Act of 1940, as amended (Advisers Act) and rules thereunder.

- See a copy of the risk alert

Litigation

SEC charges SPAC, sponsor, target and CEOs for misleading disclosures and inadequate due diligence

Copyright 2021 Davis Polk & Wardwell LLP

On July 13, 2021, the SEC announced charges relating to the planned merger of Stable Road Acquisition Company, a special purpose acquisition corporation (SPAC), and Space Transportation Company Momentus Inc., the proposed merger target. The SEC charged the target and its former CEO with making misrepresentations, and also charged the SPAC, its CEO, and the sponsor with due diligence failures. The enforcement action is notable as it is the first SEC enforcement action aimed at a SPAC since Chair Gary Gensler was sworn into his post and the SEC enforcement action occurred *prior* to closing of the proposed business combination.

For further information, please refer to Davis Polk's recent client update discussing this matter.

- See a copy of the client update
- See a copy of the press release

SEC commences administrative proceedings against audit firm, professionals, for alleged "widespread audit failures"

On July 13, 2021, the SEC issued an order (the SKR Order) commencing an administrative proceeding against Stockman Kast Ryan & Co. LLP (SKR), an accounting firm, and two of its partners, Ellen S. Fisher, CPA (Fisher) and David H. Kast, CPA (Kast). The SEC alleges that SKR, Fisher and Kast engaged in improper professional conduct by failing to conduct audits of funds managed by a registered investment adviser (the Adviser) consistent with PCAOB auditing standards. The SEC alleges that SKR and the individuals engaged in "multiple single instances … of highly unreasonable conduct" and "repeated instances of unreasonable conduct" in the course of these audits. The SEC also alleges that SKR caused the Adviser to violate the custody rule under the Advisers Act, by failing to meet the audit exception, because SKR was not independent and did not conduct the audits of the funds in accordance with GAAS.

The SEC's administrative complaint alleges that SKR had provided audit services to the Adviser and its affiliates since approximately 1999. Fisher served as the audit engagement partner for the funds, and Kast served as the audit quality review partner. The SKR Order identifies 12 audits in 2015 and 2016 with respect to which the SEC alleges that Fisher and SKR failed to plan the audits, evaluate audit results, document audit procedure, supervise the audits, and exercise professional care.

SKR and Fisher, the SEC alleges, failed to adequately assess the risks of valuations of certain level 3 assets in the funds-"hard to value" assets whose values depend on "unobservable inputs." The SKR Order details a number of alleged audit failures, including one instance in which SKR and Fisher allegedly failed to recognize that documents provided to them showed that shares valued at $1 million on a fund's financial statements had been canceled, resulting in a restatement that wrote off the entirety of the shares' value. The SEC alleges that other failures by SKR and Fisher focused on level 3 assets included:

- Failing to evaluate the qualifications of an appraiser or to test the appraisal against available data;
- Failing to perform a retrospective review after learning that an appraisal increased the value of an asset 150% as compared to an appraisal six months prior;
- Failing to identify and evaluate an overstatement of value of a real estate asset that the Adviser discovered through fieldwork;
- Failing to evaluate the appropriateness of a valuation model used by the Adviser; and
- Failing to determine whether transactions between a fund and a related person were at fair value.

As for Kast, the SEC alleges that he failed to conduct engagement quality reviews in accordance with PCAOB standards and GAAS. Kast allegedly failed to recognize the lapses in the audits that are the subject of the SKR Order, and allegedly either failed to review, or failed to document his review, of a number of the audits.

Finally, the SEC also alleges that SKR was not an "independent" auditor because, among other things, a partner of SKR (not named in the order) served as a trustee to a number of trusts that were invested in funds managed by the Adviser, and because SKR provided bookkeeping services to one of the funds that it audited.

On account of these alleged violations, the SEC seeks censure, an order to cease and desist from further violations, and civil penalties.

Over the past several years, the SEC has brought a number of enforcement actions addressing allegedly improper valuation procedures for assets that cannot be valued by reference to market prices or other observable inputs, while independence and conflicts of interest have been a perennial focus. The SKR Order notably brings together several of

Copyright 2021 Davis Polk & Wardwell LLP

those trends; in addition, because the order institutes but does not settle this action it contains a significantly greater degree of detail than most orders settling administrative proceedings.

– See a copy of the SKR order

Copyright 2021 Davis Polk & Wardwell LLP