Davis Polk

Investment Management Regulatory Update – August 2021

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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 Division of Examinations Risk Alert on observations from examinations of investment advisers managing accounts that participate in wrap fee programs

On July 21, 2021, the Division of Examinations (Division) issued a Risk Alert that highlighted common compliance and conflict of interest issues observed by Division staff in its examination initiative focused on advisers associated with wrap fee programs. The Division's focus comes as a result of continued growth of investor assets participating in wrap fee programs, which generally charge a consolidated fee for investment advisory services and execution of transactions.

Staff observations and scope of examination initiative

The Division noted that its examination was primarily focused in three areas: (1) consistency with fiduciary duty obligations; (2) the adequacy of the examined advisers' disclosures; and (3) the effectiveness of the examined advisers' compliance programs.

Consistency with fiduciary duty obligations. Here, the Division examined whether the "advisers had fulfilled their fiduciary duty by having a reasonable basis to believe that the wrap fee programs were in the best interests of participating clients" and whether those assessments were documented. The staff observed that in some cases, advisers were breaching their fiduciary duty to clients and making recommendations that were not in the client's best interest. More specifically, the staff observed that advisers were either not monitoring, or providing insufficient monitoring, with regard to trading activity in clients' accounts. For example, according to the Risk Alert, some advisers recommended that clients continue to engage in the wrap fee programs, without monitoring for and taking into account costs incurred by clients in "trading away" from brokers offering bundled brokerage services, or low trading activity for client accounts. The staff observed that these advisers' recommendations that clients engage in or continue with their wrap fee program were made without assessing whether these recommendations were in the best interests of the clients.

The adequacy of the examined advisers' disclosures. Here, the Division reviewed whether "the examined advisers provided full and fair disclosures of all material facts to their clients participating in the wrap fee programs, particularly regarding the fees, expenses, conflicts of interest, and entities involved in the program[; and] whether the agreements between the examined advisers and the wrap fee program sponsors, portfolio managers, any solicitors referring clients to the wrap fee program, and other service providers sufficiently disclosed which parties would be fulfilling certain core responsibilities for the participating wrap fee clients' accounts." The staff observed that in some cases, the advisers provided misleading, or altogether omitted, disclosures to clients (including with respect to conflicts of interest, fees, and expenses). More specifically, the staff found inconsistent disclosures in the same document in various instances as well as failures to disclose conflicts of interest. The omitted disclosures often pertained to financial incentives that advisers were receiving if they made certain recommendations.

The effectiveness of the examined advisers' compliance programs. Here, the Division analyzed "the effectiveness of the examined advisers' compliance policies and procedures and other processes, particularly those for determining whether the wrap fee programs and accounts were in the best interests of their clients." The staff's observations included an analysis of existing compliance programs, which resulted in the finding that many advisers had "weak or ineffective compliance policies and procedures relating to their wrap fee programs." More specifically, the staff found that in many cases, advisers did not have written compliance policies and procedures in place, particularly with regard to best interest reviews for the purpose of recommending wrap fee accounts to clients. The staff also found that even when advisers did have written compliance policies, some were inadequate and some were inconsistently enforced. Finally, the staff noted that a few of the advisers did not conduct, or conducted inadequate, annual compliance reviews.

Staff observations regarding industry practices

In its Risk Alert, the Division provided the below examples of policies to aid advisers in remedying the areas of concern discussed above.

Fiduciary Duty and Recommendations Made in Clients' Best Interest. The staff observed that some advisers have implemented review programs wherein wrap fee recommendations are evaluated to assess whether they were in the best interests of clients. Advisers conducted interviews and/or distributed questionnaires to obtain information directly from clients and used it to evaluate clients' specific personal situations and determine the appropriateness of future recommendations. The staff also observed that, after conducting these initial reviews, advisers reminded clients to report any changes to their personal situations and/or investment objectives that may affect the initial assessment documentation. Finally, the staff observed advisers providing background and education to clients before recommending that they convert their accounts from non-wrap fee to wrap fee programs.

Disclosures. The staff observed that advisers made an effort to provide clients with disclosures regarding the advisers' conflicts of interest with regard to wrap fee programs. The staff provided the following examples of disclosures that were provided to clients by advisers recommending wrap fee programs:

- The advisers receive compensation or incentives from wrap fee program sponsors or portfolio managers for investing client assets through the wrap fee programs (e.g., soft dollars, forgivable loans, technology, or other services provided).
- The advisers have financial incentives not to migrate infrequently traded wrap fee accounts to brokerage or non-wrap advised accounts.
- The advisers or their supervised persons have incentives not to trade in clients' accounts because they may be responsible for paying ticket charges or other costs.

– Clients may incur more costs by participating in the wrap fee program than if they received similar services provided in other types of accounts.
– Clients would pay share class charges¾such as 12b-1 fees¾when lower-cost alternative classes of the same fund may be available, and that such fees would be paid to the advisers' supervised persons.

The staff also observed that it was helpful for advisers to specifically alert clients as to which services and/or expenses will not be included in the wrap fee.

Compliance Programs. First, the staff observed that one beneficial addition to existing written compliance policies is a set of factors to use when the adviser is assessing whether or not to recommend a client participate in a wrap fee program. Certain advisers even took it a step further and put procedures in place to ensure the factors were being complied with, including conducting reviews of client documentation and using the adviser's resources to promote compliance. Second, the staff noted that effective compliance programs also monitor the adviser's trading behaviors to ensure that potentially problematic trading activity was identified and accounted for when considering whether the wrap fee recommendation should be made to the client (e.g., low trading activity). Finally, the staff observed that compliance programs should incorporate an assessment on whether wrap fee programs remain in the client's best interests given the frequency of the adviser's trading, and when it becomes apparent that the wrap fee program is no longer in the client's best interests, the wrap fee account should be either moved to brokerage accounts or another type of advisory arrangement.

Conclusion

The staff noted that most examined advisers "elected to amend disclosures, revise compliance policies and procedures, conduct suitability reviews of wrap fee clients, or change other practices." The Division concluded by encouraging advisers who recommend wrap fee programs to contemplate policies and procedures that address the risks, conflicts, and challenges outlined in the Risk Alert.

– See a copy of the Risk Alert

SEC Division of Investment Management staff release analysis of prime money market fund buffers

On July 21, 2021, the Division of Investment Management released an analysis of data on the composition of liquidity buffers for prime money market mutual funds (Prime MMFs) for the period from October 2016 to May 2021. The article examined data reported by Prime MMFs on Form N-MFP and on their public websites regarding the composition of liquidity buffers during such time period, which included the period of heightened market volatility following the onset of the pandemic. According to the article, during such period, Prime MMFs on average maintained "daily liquid assets" and "weekly liquid assets," as defined under Rule 2a-7 under the Investment Company Act of 1940, well over the minimums required under the rule. The article noted that rapid shareholder redemptions can cause a fund's daily liquid assets and weekly liquid assets to fall below the minimum 10% and 30%, respectively, required under Rule 2a-7. During the onset of the pandemic in March 2020, investors withdrew $125 billion from Prime MMFs, causing a general reduction of Prime MMFs' weekly liquid assets, in one case below the 30% minimum. However, no Prime MMF reported its daily liquid assets falling below the 10% threshold in March 2020, which the article suggested demonstrates that Prime MMFs maintained sufficient liquidity to meet daily redemption requests. The article also concluded that Prime MMFs mainly rely on government securities and repos to meet their daily and weekly liquidity thresholds, with Prime MMFs' investments in U.S. government securities increasing during the pandemic, reaching an all-time high of 38% of their portfolios in August 2020.

– See a copy of the article

Litigation

SEC Form CRS sweep

The SEC brought cases against 21 investment advisers and six broker-dealers for failing to timely file and deliver client or customer relationship summaries (Form CRS) to retail investors. In June of 2019, the SEC adopted Form CRS and required SEC-registered investment advisers and broker-dealers to deliver them to existing retail investors or clients by the end of July of 2020 and post their current Form CRS on their website. The SEC's orders noted that none of the firms

filed or delivered their Form CRS until being twice reminded of the missed deadlines by regulators. All 27 of the investment advisers and broker-dealers settled their cases and agreed to pay civil penalties ranging from $10,000 to $97,523.

– See SEC press release

Law firm response to Investment Company Act lawsuits targeting the SPAC industry

Recently a purported shareholder of certain SPACs initiated derivative lawsuits asserting that the SPACs are investment companies under the Investment Company Act of 1940. The 49 law firms listed in a joint statement published on August 27, 2021, including Davis Polk, view the assertion that SPACs are investment companies as without factual or legal basis. A copy of the full text of the joint statement is available at the link below.

– See a copy of the joint statement