Davis Polk

Investment Management Regulatory Update - November 2021

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In this issue, we discuss, among other things, recent remarks by SEC Chair Gary Gensler signaling greater scrutiny for the private fund industry. Our update also highlights recent risk alerts issued by the SEC Division of Examinations.

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Rules and regulations

SEC staff statement on withdrawal and modification of staff letters related to rulemaking on investment adviser marketing

In October 2021, the staff of the Securities and Exchange Commission (SEC) Division of Investment Management (the Staff) issued an information update (October Update) regarding its withdrawal of numerous no-action letters previously issued and relating to current rule 206(4)-1 (Advertising Rule) and rule 206(4)-3 (Cash Solicitation Rule) under the Investment Advisers Act of 1940, as amended (Advisers Act). According to the October Update, the Staff's withdrawal of the no-action letters stems from the SEC's adoption of amended rule 206(4)-1 (Marketing Rule)—a single rule which will replace both the Advertising Rule and the Cash Solicitation Rule. The effective date of the withdrawals of, and modifications to, the no-action letters is November 4, 2022, the compliance date for the Marketing Rule.

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The Staff noted that it did not identify any withdrawn no-action letters regarding solicitor disqualification under the Cash Solicitation Rule that would trigger disqualification under the Marketing Rule. The Staff encourages persons with a disqualifying event within the Marketing Rule's ten-year lookback period to review their compliance policies and procedures in light of that rule's requirements.

For further information on the Marketing Rule, please refer to Davis Polk's client update dated April 1, 2021.

– See Davis Polk's client update
– See the SEC's October Update

Industry update

SEC Chair Gensler and Commissioner Peirce announce recommendations before the Asset Management Advisory Committee

On November 3, 2021, SEC Chair Gary Gensler delivered a statement before the Asset Management Advisory Committee regarding the SEC's response to evolution within the asset management sector.

Chair Gensler described recent growth within the field, citing a 58% and 130% increase in the number of private equity and venture capital funds, respectively, over the last five years. He believes that this growth, paired with recent technological, structural and strategic changes within the industry, have created new risks for markets and investors.

Chair Gensler highlighted five areas of the SEC's regulatory response to these trends:

1. Enhanced fund disclosures, including his support for proxy voting disclosures for registered funds;
2. Addressing potential conflicts of interest in the algorithms of digital engagement practices (DEPs) between maximizing returns for investors and generating revenues for platforms;
3. Fostering competition and efficiency within the private funds market through enhanced reporting and disclosure reforms, including to Form PF;
4. Requiring funds that market themselves as "green", "sustainable" or "low-carbon" to meet certain criteria and disclose supporting data;
5. Improving the resiliency of money market funds and open-end funds with insight from COVID-related market events.

Chair Gensler has requested that SEC staff prepare recommendations for proposed rule-making to address these risks.

In separate remarks, SEC Commissioner Hester M. Peirce emphasized the impact of regulations on small advisers. She supported recommendations of the Small Advisors and Small Funds Subcommittee to narrow the definition of "small entity", as it applies to advisers, and to allow advisers and funds to use electronic delivery as the default method of delivery for all communications.

– See Chair Gensler's statement and Commissioner Peirce's statement.

SEC Chair Gary Gensler signals greater coming scrutiny for the private fund industry

SEC Chair Gary Gensler signaled once again, and perhaps in the clearest terms to date, his intention to bring greater scrutiny to the private fund industry. During prepared remarks, Chair Gensler indicated that SEC staff are considering changes to practices regarding private fund fees and expenses, side letters, performance metrics, fiduciary duty and conflicts of interest, and Form PF. Davis Polk recently issued a client update discussing his remarks.

– See Chair Gensler's remarks

SEC Division of Examinations issues risk alert on observations of investment advisers' fee calculations

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On November 10, 2021, the Division of Examinations (Division) issued a Risk Alert that highlighted findings from its recently concluded national initiative focusing on advisory fees, predominantly those charged to retail clients (Initiative). This Risk Alert followed up on a prior Risk Alert the Division published on April 12, 2018 highlighting compliance issues the staff had observed related to advisory fees.

Staff observations and scope of Initiative

The staff noted the Initiative was primarily focused on three areas: (1) the accuracy of the fees charged by the examined advisers; (2) the accuracy and adequacy of the examined advisers' disclosures; and (3) the effectiveness of the examined advisers' compliance programs and accuracy of their books and records. All of the examined advisers provided investment advice to retail clients, but they varied widely with respect to assets under management, business operations, staffing levels and affiliations.

The accuracy of the fees charged by the examined advisers. The staff observed that several examined advisers charged fees inaccurately, resulting from a variety of errors.

- Some examined advisers used inaccurate percentages to calculate advisory fees. This could result from (1) charging fees that differed from those contractually agreed upon, (2) using incorrect fee schedules, (3) failing to convert all clients to an applicable updated fee schedule, and (4) errors in the manual entry of fee percentages.
- Some advisory fees were double-billed, typically due to system updating oversights.
- Some breakpoint or tiered billing rates were not correctly calculated, often due to tiered fee schedules being applied incorrectly or not at all.
- The householding of some client accounts was not correctly calculated, resulting, for example, from the failure to aggregate accounts and/or apply an applicable declining fee schedule.
- Some advisers used incorrect client account valuations, resulting from the inclusion of, for example: (1) assets that disclosures stated would be excluded from fee calculations, (2) stale account balance information, (3) incorrect valuation dates for billings, and (4) inaccurate account values resulting from timing differences in cash and dividend transactions in electronic custodial feeds compared to the custodian's available balance.

In addition, the staff observed that several examined advisers either did not refund prepaid fees on terminated accounts or did not assess new account fees on a pro rata basis. Some required written requests from clients to obtain such refunds, leading to advisers' retention of unearned fees for clients that either terminated through their custodians or failed to specifically request a refund.

The accuracy and adequacy of the examined advisers' disclosures. The staff identified a range of disclosure issues stemming from incomplete or misleading Form ADV Part 2 brochures and/or other disclosures, such as the failure to reflect current fees charged and whether fees were negotiable, inadequate descriptions of how fees would be calculated or billed, and inconsistencies across advisory documents.

Some examples of fee-related disclosure issues the staff identified include:

- Disclosures that were inconsistent with the examined adviser's practice or insufficient in describing how cash flows may impact fees
- Inaccurate or insufficient disclosures as to the timing of the examined adviser's fee billing
- Inaccurate disclosures about the values used to calculate fees
- Lack of disclosure on other topics such as platform administration fees, actual or minimum asset-based fee rates, negotiability of fees, householding implementation process and eligibility, and fees related to wrap fee programs and non-wrap accounts

The effectiveness of the examined advisers' compliance programs and accuracy of their books and records. The staff observed that many of the examined advisers did not maintain written policies and procedures addressing advisory fee billing, monitoring of fee calculations and billing, or both. The staff reported a variety of critical components missing in some policies and procedures, including: (1) valuation of illiquid or difficult-to-value assets included in the assets for the calculation of advisory fees; (2) fee offsets, such as those offered for 12b-1 fees; (3) fee reimbursements for terminated accounts, where the client prepaid fees; (4) prorating fees for additions or subtractions of assets in accounts; and (5) householding or the application of breakpoints for fee calculations.

The staff also observed fee-related issues with several examined advisers' financial statements, including those in potential financial distress and those not properly recording pre-paid advisory fees as liabilities. The staff observed that

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some examined advisers did not record all advisory fee income, administrative fee revenue, and compensation expenses in general ledgers and on financial statements because they were exchanged for other goods and services or because they did not record advisory fees paid directly to investment adviser representatives. Further, some examined advisers used a cash and modified cash basis of accounting while preparing accrual-basis financial statements.

Staff observations regarding industry practices

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

Written Policies and Procedures. The staff noted it observed fewer errors when the examined adviser had specific written policies and procedures addressing the supervision, calculation, review, and billing of advisory fees.

Centralized Fee Billing. According to the Risk Alert, examined advisers practicing centralized billing showed fewer bills that were incorrect or inconsistent with written policies and procedures.

Tools for Reviewing Fee Calculations. The staff noted the utility of tools like checklists for reconciling fee calculations with advisory agreements.

Recording Advisory Expenses and Fees. The staff emphasized that advisers should properly record all advisory expenses and fees assessed to and received from clients, including those paid directly to advisory personnel.

Conclusion

The staff noted that its findings often lead to advisers returning money owed to clients due to fee billing and calculation issues or to the improvement of compliance policies and procedures designed to prevent future advisory fee issues. The Division concluded by encouraging advisers to review and improve, as appropriate, their fee billing policies and practices, address new risks as they are identified, and review their disclosures regarding such practices.

– See the Risk Alert

SEC Division of Examinations issues risk alert on observations from examinations in the Registered Investment Company (RIC) initiatives

On October 26, 2021, the Division of Examinations (Division) issued a Risk Alert that highlighted common compliance issues observed by Division staff in its RIC initiatives. Under the RIC initiatives, mutual funds, exchange-traded funds and their investment advisers that fell into one or more of the following six categories were examined: (1) index funds that track custom-built indexes; (2) smaller ETFs and/or ETFs with little secondary market trading volume; (3) mutual funds with higher allocations to certain securitized investments; (4) mutual funds with aberrational underperformance relative to their peer groups; (5) mutual funds managed by advisers that are relatively new to managing such funds; and (6) advisers that provide advice to both mutual funds and private funds, both of which have similar strategies and/or are managed by the same portfolio managers.

Staff observations and scope of examination initiative

The Division noted that its examinations were tailored to account for the specific characteristics of the category in which a fund or its adviser fell into. However, across all examinations the Division generally examined: (1) effectiveness of the compliance programs; (2) disclosures by the funds to their investors; and (3) fund governance practices.

Effectiveness of the compliance programs. Here, the Division observed that some funds and their advisers “did not establish, maintain, update, follow and/or appropriately tailor their compliance programs to address various business practices, including portfolio management, valuation, trading, conflicts of interest, fees and expenses, and advertising.” For instance, with respect to compliance oversight of portfolio management, the staff observed that among other deficiencies, some funds did not monitor for “adherence to each fund’s specific investment restrictions.” With respect to compliance oversight of valuation, the staff found that a common weakness was the inadequate maintenance of a compliance program that provides for due diligence and oversight of pricing vendors that supply evaluated prices for portfolio holdings for purposes of calculating the fund’s daily net asset values. With respect to compliance oversight of trading practices, the staff observed that in some cases, the funds did not prevent prohibited principal transactions with affiliates, prohibited joint transactions with affiliates, or both. With respect to compliance oversight of conflicts of interest, one of the issues noted by the staff involved the failure to address advisers’ conflicts of interest when they serve both as an adviser to an index fund and the index provider. In addition, the staff observed issues related to compliance oversight of fees and expenses, such as deficiencies in monitoring allocation of expenses between funds and their advisers. Lastly,

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the staff observed compliance oversight of fund advertisements and sales literature, noting issues such as failures to assess whether affiliated index providers' websites – accessible through hyperlinks in the statements of additional information (SAIs) of self-indexing funds – may be deemed fund sales literature that warranted filing with the SEC or FINRA.

Disclosures by the funds to their investors. Here, the Division observed deficient disclosures to investors by funds in several aspects of their shareholder communications, including fund filings, advertisements, and sales literature. The staff observed that in some cases, the funds provided inaccurate, incomplete, or altogether omitted, disclosures in their filings, with respect to subjects such as investment risks, potential conflicts in investment opportunities allocation resulting from overlapping investment strategies, and change in the broad-based indexes used for comparison of funds' performance. In addition, the staff found inaccurate and misleading disclosures on a variety of advertising and sales literature-related topics, including, but not limited to, the differences in investment objective between predecessor and successor funds, inception dates, and issues related to funds' expenses.

Fund governance practices. Here, the staff's observations pertained to "issues with funds' policies and procedures for their boards' oversight of the funds' compliance programs." For example, the staff found that in many cases, the funds did not have appropriate policies, procedures and processes for monitoring and reporting to their boards with accurate information. The staff also found that some funds did not have adequate processes for ensuring that the boards consider annually whether their adviser "has any financial condition that is reasonably likely to impair its ability to meet its contractual commitments to clients." In addition, among other deficiencies, the staff noted failures by some funds to complete required annual reviews of their compliance programs.

Staff observations regarding industry practices

In its Risk Alert, the Division provided the below examples of practices to aid funds and their advisers in designing and implementing their compliance programs.

Compliance programs. The staff observed that some funds and their advisers have implemented compliance programs that provided for review of compliance policies and procedures for consistency with practices. For example, these funds reviewed their advisers' compliance manuals pertaining to specific risk areas for which the funds had delegated responsibility to their advisers. The staff also observed that some funds conducted assessments of compliance policies and procedures to mitigate conflicts of interest issues, such as through reviewing trade and expense allocation policies and procedures in light of potential conflicts resulting from management of various accounts by the same adviser. In addition, the staff observed that some funds implemented written pricing vendor oversight processes wherein variance reports on stale or outlier prices were reviewed. Finally, the staff noted adoption of policies and procedures by some funds to ensure compliance with applicable regulations and exemptive orders and to avoid undisclosed conflicts of interest.

Disclosures. The staff provided the following examples of policies and procedures concerning disclosure, which some funds have adopted as requirements:

- Review and amendment of disclosures in funds' prospectuses, SAIs, shareholder reports or other investor communications consistent with the funds' investments and investment policies and restrictions.
- Amendment of disclosures for consistency with actions taken by the funds' boards, as applicable.
- Update of funds' website disclosures concurrently with new or amended disclosures in funds' prospectuses, SAIs, shareholder reports or other client communications.
- Review and testing of fees and expenses disclosed in funds' prospectuses, SAIs, shareholder reports or other client communications for accuracy and completeness of presentation.
- Review and testing of funds' performance advertising for accuracy and appropriateness of presentation and applicable disclosures.

Fund governance practices. The staff observed that some funds have strengthened their boards' oversight of the funds' compliance programs by examining whether the information the board received was accurate, specifically with respect to areas such as the funds' fees, expenses and performance, and the funds' investment strategies and associated risks. Additionally, some funds examined whether they were adhering to their processes for board reporting by conducting annual reviews of the funds' compliance program.

Conclusion

The staff noted that most examined fund and their advisers "revised their compliance policies and procedures, amended disclosures, or changed certain practices." The Division concluded by encouraging funds and their advisers to review

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their existing practices, policies, and procedures in areas outlined in the Risk Alert and consider improvements respectively.

– See the Risk Alert

SEC Division of Examinations issues risk alert on observations from examinations of advisers that provide electronic investment advice

Introduction

On November 9, 2021, the SEC's Division of Examinations (Division) published a risk alert regarding deficiencies in investment advisers providing advice electronically (commonly known as "robo-advisers").

The Division noted that the number of investment advisers that are providing online investment advisory services to retirement plan participants and retail investors has substantially increased. The Division is concerned that "[m]illions of investors … now entrust their savings to advisers that provide their investment advisory services online, via mobile applications, or both (also known as robo-advisers)." The basis for this concern is robo-advisers' potential failure to comply with regulatory obligations. The Division provided the example that in the event that "a robo-adviser's client survey process does not appropriately capture a client's risk tolerance, it could result in advice to invest in securities that are not aligned with the client's best interest."

Given these concerns, the Division launched the Electronic Investment Advice Initiative (Initiative) to investigate the practices of the robo-advisers, and, more specifically, to learn whether they were satisfying their regulatory obligations under the Advisers Act. The Division focused on "how robo-advisers were upholding their fiduciary duty to:

1. provide clear and adequate disclosure regarding the nature of the advisers' services and performance history; and
2. act in their clients' best interests.

Examination focus and relevant regulations

The examination focused on four main areas: (i) compliance programs; (ii) formulation of investment advice; (iii) marketing and performance advertising practices; (iv) data protection practices; and (v) registration information.

Use of discretionary investment advisory programs

According to the risk alert, certain discretionary investment advisory programs may meet the definition of an "investment company" under the Investment Company Act of 1940, as amended (Company Act), for which there is a safe harbor. The Division advises that to the extent an investment adviser "sponsors or operates a discretionary investment advisory program[, they] should consider the program's status under the Company Act." If they choose to rely on the relevant safe harbor, they should ensure that their program is in compliance with its conditions.

Staff observations

The Division noted in its risk alert that almost all of the advisers it examined received a deficiency letter. The most commonly noted deficiencies included:

1. compliance programs, including policies, procedures, and testing;
2. portfolio management, including, but not limited to, an adviser's fiduciary obligation to provide advice that is in each client's best interest; and
3. marketing/performance advertising, including misleading statements and missing or inadequate disclosure.

Electronic investment advice. The Division found that many of the advisers it examined were running insufficient compliance programs. Namely, there was a lack of written policy, and for the advisers that did have programs, some of them were unimplemented and/or unreviewed. Furthermore, some advisers did not include elements in their compliance programs to assess algorithms were performing as intended, as well as privacy problems associated with the advisers' business-to-business online platforms. The Division also noted that many advisers were failing to comply with the "Code of Ethics Rule."

The Division further noted that the examined advisers "lacked written policies and procedures that would allow the firms to develop a reasonable belief that the investment advice being provided to clients was in each client's best interest based on the client's objective, or adopted policies and procedures that were inadequate or not followed." While the advisers were using various questionnaires to collect information and data points, the Division noted concerns that

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advisers were not receiving sufficient information to be able to assess whether their advice was suitable and appropriate for clients.

Another finding was that many of the advisers were producing inaccurate or incomplete Form ADV filings, including those related to: (i) conflicts of interest, (ii) advisory fees, (iii) investment practices, and (iv) ownership structure. The Division provided examples of these inaccurate or incomplete disclosures in its Risk Alert.

The Division found that more than half of the advisers had advertisement-related deficiencies, including the following:

"(1) using vague or unsubstantiated claims that could cause an untrue or misleading implication or inference to be drawn regarding the advisory services provided, investment options available, performance expectations, and costs incurred in investing (e.g., a comparative analysis of adviser-offered versus other products and services);

(2) misrepresenting SIPC protections by implying that client accounts would be protected from market declines;

(3) using press logos (e.g., ABC, CNN, Forbes) without links or disclosure that would explain their relevance; and

(4) referring to, or providing links to, positive third-party commentary, without disclosing the relevance, any conflict of interest (e.g., adviser compensation), or both."

Another issue that was uncovered during the examination was the lack of cybersecurity and protection of client information. Few of the advisers had programs in place to detect, prevent and mitigate identity theft and/or delivery privacy notices to investors, even when required to do so.

Finally, the Division noted several issues with regard to registration. Many of the examined advisers were claiming reliance on the 'internet adviser' exemption, but the staff observed that many did not qualify for such exemption because, for example, they did not have interactive websites.

Discretionary investment advisory programs. The Division also noted the following in its risk alert:

- Reliance on the nonexclusive safe harbor provisions of Rule 3a-4. The Division expressed concern that many of the examined advisers were providing non-individualized advice and were unaware that their programs may be unregistered investment companies. The Division noted that some advisers claiming to rely on the Rule 3a-4 safe harbor were not in compliance with its requirements.
- Establishing client accounts. Despite requirements that advisers obtain detailed client information in order to establish their accounts and provide personalized advice, the Division found that many advisers were using insufficient questionnaires and impeded clients' ability to impose reasonable restrictions on their accounts.
- Ongoing communications. The Division noted that "[a]n adviser relying on the safe harbor must contact each client at least annually to: (1) update the client's financial situation or investment objectives; and (2) determine if the client wishes to impose any reasonable restrictions on the management of the client's account or reasonably modify existing restrictions." The Division found that there were many deficiencies with advisers meeting these requirements.
- Account statements. The safe harbor under Rule 3a-4 requires advisers to provide clients with periodic account statements. The Division found observed general compliance with this requirement.
- Client rights. While Rule 3a-4 requires that clients possess "certain indicia of ownership" over their securities, the Division found that many advisers were: (i) imposing restrictions on their clients' ability to access their securities; (ii) disallowing clients from voting on behalf of their security ownership; (iii) deficient in providing documents that clients had a right to receive; and (iv) disallowing clients to take legal recourse as security holders.

Ways to improve compliance. The Division proposed several ways in which it believes compliance may be improved. First, advisers should adopt, implement and follow written policies and procedures that are specific to each adviser's practice. Second, advisers should regularly test the algorithms it is using to ensure that they are working properly. Finally, advisers should protect and safeguard those algorithms to ensure there are no changes to the algorithms that the adviser is unaware of, or any issues with its use.

- See the Risk Alert

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