Davis Polk

Investment Management Regulatory Update - February 2023

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In this issue we discuss, among other things, SEC Division of Investment Management guidance regarding registered funds and differential advisory fee waivers, SEC Division of Examinations priorities for 2023, and a recent enforcement action involving an adviser's alleged conflict of interest with respect to revenue sharing and incentive arrangements.

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Rules and regulations

SEC Division of Investment Management issues guidance on registered funds and differential advisory fee waivers

On February 2, 2023, the Securities and Exchange Commission (SEC) Division of Investment Management staff (the Staff) issued a bulletin to remind mutual funds and their boards of directors about the potential implications of fee waiver and expense reimbursement arrangements that result in different advisory fees being charged to different share classes of the same fund (differential advisory fee waivers).

Rule 18f-3 (the Rule) of the Investment Company Act of 1940 (the Investment Company Act) provides an exemption to allow open-end funds to issue multiple classes of shares, which would otherwise be prohibited under Sections 18(f)(1) and 18(i) of the Investment Company Act. Among other things, the Rule requires class voting for certain matters, and

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fund board approval for a plan setting forth the separate arrangement and expense allocation for each class based on a finding that the plan is in the best interests of each class individually and of the fund as a whole.

The Staff explained that, although the Rule expressly allows expenses to be waived or reimbursed by a fund's adviser, the SEC did not intend such arrangements to become "*de facto* modifications of the fees provided for in advisory or other contracts so as to provide a means for cross-subsidization between classes." The Staff emphasized that advisory fees charged to shareholders of all classes of a mutual fund should generally be the same percentage amount. The Staff highlighted that differential advisory fee waivers that are long-term or permanent, or effectively long-term or permanent, could constitute prohibited cross-subsidization between classes. The Staff noted that whether a differential advisory fee waiver presents a prohibited means of cross-subsidization between classes is a facts-and-circumstances determination that a fund's board, in consultation with the adviser and counsel, should make and document after considering all relevant factors.

The Staff suggested that the board of a fund operating within a fund-of-funds structure could conclude that a long-term advisory fee waiver for one class of shares, but not for other classes of shares, does not constitute cross-subsidization if (i) shareholders in the waived class pay fees to the adviser at the investing fund level and (ii) such fees, when added to the advisory fees paid by the waived class, after giving effect to the waiver, are at least equal to the amount of advisory fees paid by the other classes.

The Staff concluded by encouraging boards of funds that already have differential advisory fee waivers in place to consider whether such waivers constitute cross-subsidization, whether appropriate steps are being taken to monitor such waivers to guard against cross-subsidization, and whether alternative fee arrangements may be appropriate. The Staff also advised boards to consider the extent to which the board's consideration of these issues should be disclosed to the fund's shareholders.

Industry update

SEC Division of Examinations releases examination priorities for 2023

On February 7, 2023, the SEC Division of Examinations (Division) published its examination priorities for 2023 (Exam Priorities). The notable new and significant focus areas of the Exam Priorities include: (1) compliance with recently adopted rules under the Investment Advisers Act of 1940 (Advisers Act) and Investment Company Act, (2) registered investment advisers (RIAs) to private funds, (3) standards of care and (4) Environmental Social and Governance (ESG) investing. The Exam Priorities also noted a focus on information security and operational resiliency, emerging technologies and crypto assets, and preparedness for the discontinuation of LIBOR. For a discussion of the 2022 Exam Priorities, please see the April 29, 2022 Investment Management Regulatory Update.

Recently adopted rules under the Advisers Act and Investment Company Act

According to the Exam Priorities, the Division will prioritize examining for compliance with three recently adopted rules.

– **Advisers Act Rule 206(4)-1 (Marketing Rule)**: Recognizing that the new Marketing Rule is a significant change to a core examination review area for RIAs, the Division highlights two specific areas for review: (i) whether RIAs have adopted and implemented written policies and procedures reasonably designed to prevent Marketing Rule violations; and (ii) whether RIAs have complied with the substantive requirements of the Marketing Rule, such as having a reasonable basis for believing they can substantiate material statements of facts and compliance with the requirements related to performance advertising, testimonials, endorsements and third-party ratings.
– **Investment Company Act Rule 18F-4 (Derivatives Rule)**: If a fund relies on the Derivatives Rule, the Division will assess, among other things, whether the fund has adopted policies and procedures reasonably designed to manage the funds' derivatives risks and prevent violations of the Derivatives Rule pursuant to Investment Company Act Rule 38a-1. The Division will also review for compliance with Rule 18f-4, including adoption and implementation of derivatives risk management programs, board oversight, and the completeness and accuracy of a fund's disclosures concerning its use of derivatives.
– **Investment Company Act Rule 2a-5**: The Division will, among other things: (i) assess funds' compliance with the new requirements for determining fair value, implementing board oversight duties, setting recordkeeping and reporting requirements, and allowing valuation designees to perform fair value determinations subject to oversight by fund boards; and (ii) review whether adjustments have been made to valuation methodologies, compliance policies and procedures, governance practices, service provider oversight, and/or reporting and recordkeeping.

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RIAs to private funds

According to the Exam Priorities, the Division plans to continue to focus on RIAs that manage private funds. Examinations will focus on conflicts of interest, the calculation and allocation of fees and expenses, compliance with the new Marketing Rule (e.g., performance advertising and compensated testimonials and endorsements, such as solicitations), policies and practices regarding the use of alternative data and compliance with Advisers Act Section 204A, and compliance with the custody rule under the Advisers Act (e.g., timely delivery of audited financials and selection of permissible auditors). The Division will also focus on RIAs to private funds with specific risk characteristics, including highly leveraged private funds, private funds managed side-by-side with BDCs, private equity funds that use affiliated companies and advisory personnel to provide services to fund clients and portfolio companies, funds that hold certain hard-to-value investments (e.g., crypto assets and real estate-connected assets, with an emphasis on commercial real estate), private funds that invest in or sponsor SPACs, and private funds involved in adviser-led restructurings (e.g., stapled secondary transactions and continuation funds.)

Standards of care

According to the Exam Priorities, the Division will continue to focus on broker-dealers' and RIAs' compliance with applicable standards of conduct, and noted the Division's continued interest in broker-dealers and dually registered RIAs, as well as affiliated firms with professional staff who service both brokerage customers and advisory clients. The examinations will focus on (i) investment advice and recommendations with regard to products, investment strategies, and account types; (ii) disclosures made to investors and whether they include all material facts related to conflicts of interest; (iii) the processes for making best interest evaluations (e.g., reviewing reasonably available alternatives, evaluating costs and risks, and identifying and addressing conflicts of interest); and (iv) which factors were considered in light of an investor's investment profile (e.g., investment goals and account characteristics). The Division will also focus on reviewing whether RIAs' conflict of interest disclosures are sufficient such that a client can provide informed consent to the conflict, whether express or implied.

The Exam Priorities noted that examinations may focus on advice or recommendations to certain types of investors (e.g., seniors and retirement accounts) and advice or recommendations regarding: (1) complex products, (e.g., derivatives and leveraged exchange-traded funds, exchange-traded notes, and other exchange-traded products); (2) high cost and illiquid products, such as variable annuities and non-traded REITs; (3) proprietary products; (4) unconventional strategies that purport to address rising interest rates; and (5) microcap securities.

The Division will also examine the economic incentives that a firm and its financial professionals have to recommend products, services, or account types (e.g., the source and structure of compensation, revenue, or other benefits). According to the Exam Priorities, examinations will review whether the firm has established, and periodically reviewed and updated, its written policies and procedures to identify such conflicts of interest, and how firms manage conflicts of interest, including mitigation or elimination of conflicts of interest, as appropriate. The Division will also review whether compliance policies and procedures are tailored to the firm's particular business model, compensation structure, product menu and customer base, and whether they sufficiently support compliance. The Exam Priorities noted that: "[s]uch economic incentives may include revenue sharing, commissions (including markdowns and markups), or other incentivizing revenue arrangements (e.g., conflicts often exist if firms use the services of, or invest in the products offered by, an affiliate, particularly when these arrangements result in additional or higher fees to investors)."

The Exam Priorities also noted that examinations will review whether firms have customer or client agreements that aim to inappropriately waive or limit their standard of conduct (e.g., hedge clauses), and whether firms are complying with Form CRS.

ESG investing

Recognizing that the demand for ESG-related investments continues to rise, the Division will continue to focus on ESG-related advisory services and fund offerings. In particular, it will examine whether the funds are operating in the manner set forth in their disclosures. Additionally, the Division will assess whether ESG products are appropriately labelled and whether recommendations of ESG products are made in the investors' best interest.

Information security and operational resiliency

According to the Exam Priorities, the Division will continue to review broker-dealers' and RIAs' practices to prevent interruptions to critical services and to protect investor information, records, and assets. Examinations will focus on firms' policies and procedures, governance practices, and response to cyber-related incidents (e.g., ransomware attacks), and

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compliance with Regulations S-P and S-ID. Examinations will review practices to prevent account intrusions and safeguard customer records and information, including personally identifiable information and information stored through a third-party provider, and whether the location of such records has been properly disclosed to the SEC, where required. The Division will focus on the cybersecurity issues arising from the use of third-party vendors, including transparency into the security and integrity of such third-party vendors' products and services, as well as unauthorized use of third-party providers (e.g., transition assistance when departing RIA personnel migrate client information to another firm). The Exam Priorities also noted that the Division will continue to assess systemically significant registrants' operational resiliency planning (e.g., efforts to address climate-related risks).

Emerging technologies and crypto-assets

According to the Exam Priorities, the Division has continued to see the growth of crypto investments and emerging financial technology (e.g., robo-advisers, automated investment advice and tools) and will accordingly conduct examinations of broker-dealers and RIAs offering such new products and services. The Division will focus on the offer and sale of, or advice related to the trading of, crypto-related assets, with a particular emphasis on whether markets participants met their respective standards of care and routinely reviewed, updated, and enhanced their compliance, disclosure, and risk management practices. New or never before examined registrants offering crypto-related assets will be a particular focus of the Division.

Additionally, examinations will focus on firms that employ digital engagement practices and their related tools to assess whether: (i) recommendations were made or advice was provided through these channels; (ii) representations are fair and accurate; (iii) operations are consistent with disclosures made to investors; (iv) advice and recommendations are in the best interest of the investor with their financial situation and investment objectives in mind; and (v) risks associated with such practices are considered in light of the impact these practices may have on certain investors such as seniors.

Focus areas involving RIAs and investment companies

The Exam Priorities noted that the Division's examinations of RIAs typically review the RIA's compliance programs and related disclosures in certain core areas, e.g., custody and safekeeping of client assets, valuation, portfolio management, and brokerage and execution. Other typical topics of review noted in the Exam Priorities include conflicts, compliance issues, and oversight and approval processes related to RIA fees and expenses (e.g., the calculation of fees, alternative revenue-maximizing strategies such as revenue earned on clients' bank deposit sweep programs, excessive fees).

As noted in the Exam Priorities, examinations of RIAs will also review RIA policies and procedures for: (i) retaining and monitoring electronic communications; and (ii) selecting and using third-party service providers. RIAs that have never been examined, as well as RIAs that have not been examined for a number of years, will be priorities for the Division.

According to the Exam Priorities, the Division will continue to prioritize examinations of registered investment companies, including mutual funds and ETFs. Examinations will review, among other things: registered investment companies' compliance and governance programs and practices, disclosures to investors, and accuracy of reporting to the SEC, as well as the fiduciary obligations of their RIAs, e.g., with respect to the receipt of compensation for services, or other material payments. The Division will continue to evaluate fund boards' processes for evaluating and approving advisory and other fund fees, especially for funds with relatively weak performance as compared to peers. The Division will also assess funds' derivatives risk management programs and liquidity risk management programs, as applicable.

The Division will also focus on funds with the following specific characteristics: (i) turnkey funds, to review their operations and assess effectiveness of their compliance programs; (ii) mutual funds that converted to ETFs, to assess governance and disclosures associated with the conversion to an ETF; (iii) nontransparent ETFs, to assess compliance with the conditions and other material terms of their exemptive relief; (iv) loan-focused funds, such as leveraged loan funds and funds focused on collateralized loan obligations, for liquidity concerns and to review the impact of elevated interest rates; and (v) medium and small fund complexes that have experienced excessive staff attrition, to determine if such attrition has affected the funds' controls and operations. Volatility-linked and single-stock ETFs will also be a focus of the Division.

The Division will prioritize registered investment companies that have never been examined, and those that have not been examined in a number of years. The Exam Priorities noted that such examinations typically focus on: corporate governance, the advisory contract approval process, fund code of ethics, practices that deviate from disclosures, and the implementation and effectiveness of the fund's compliance program, including the oversight of service providers.

AML programs

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The Division will continue to focus on examining investment companies for compliance with their AML obligations, including whether firms have established appropriate customer identification programs and whether they are satisfying their suspicious activity report filing obligations, conducting ongoing due diligence on customers, complying with beneficial ownership requirements and conducting robust and timely independent tests of their AML programs.

SEC Commissioner Uyeda issues remarks regarding ESG investing

On January 27, 2023, SEC Commissioner Uyeda delivered remarks at the gathering of the California '40 Acts Group, discussing his views on issues related to ESG investment strategies.

Growth of ESG investing

Commissioner Uyeda commented on the growing impact of ESG investing on the asset management industry, quoting estimates that global ESG assets are expected to exceed one third of total projected global assets by 2025 at $50 trillion, compared to $35 trillion in 2020. While the popularity of ESG products is growing, Commissioner Uyeda explained that it can be difficult to determine what assets are truly ESG products, as asset managers are incentivized to label products as being "ESG," sometimes inappropriately, in order to extract the higher management fees that ESG products typically charge compared to non-ESG products. Commissioner Uyeda then laid out his thoughts on the potential approaches to regulating ESG investing.

Fiduciary duty of investment advisers

Commissioner Uyeda first noted that under the existing Advisers Act regulatory framework, investment advisers owe fiduciary duties to their clients, and an adviser and its client may shape the advisory relationship by agreement, only if there is full and fair disclosure and informed consent. Commissioner Uyeda noted that as is the case with other investment strategies, advisers can only pursue an ESG investment strategy if the client has received full and fair disclosure of the strategy's features and risk and return profile, and the client has agreed to it. He explained that such existing regulatory framework has been applied in the ESG context, and noted a recent enforcement action in May 2022 against an investment adviser for making misstatements and omissions about its ESG considerations when making investment decisions for certain mutual funds that it managed. In Commissioner Uyeda's view, "[a] straightforward regulatory approach would treat ESG investing like any other investment strategy and apply this well-established framework, rather than impose a specific ESG regulation."

Difficulties in creating ESG regulatory frameworks

Commissioner Uyeda highlighted three factors that complicate attempts to establish "ESG"-specific regulatory frameworks:

1. The definition of "ESG." As stated in the proposing release for the SEC's recently proposed ESG rule for investment advisers and investment companies, the SEC recognizes that there are a "variety of perspectives concerning what ESG investing means, the issues or objectives it encompasses, and the ways to implement an ESG strategy." Commissioner Uyeda noted that because the goals of ESG investing can often be something other than financial performance, it can be difficult to categorize or assess the efficacy of ESG investments, and even harder to standardize ESG regulatory measures. According to Commissioner Uyeda, the impracticality of a universal "ESG" definition creates the potential for abuse that can drive assets to particular companies based on social or political agendas. He notes that there are already existing standards in place under the federal securities laws to address "greenwashing" concerns. Such standards require advisers to provide full and fair disclosure to investors on what and adviser means when it uses the term "ESG", and would require those materially utilizing third-party ESG ratings as inputs for its ESG strategy to disclose the identity of the rating firm and its methodology. Given this existing framework, Commissioner Uyeda notes that it is unclear why additional rulemaking is needed in this area.
2. Attempts by regulators to favor ESG investing. Commissioner Uyeda voiced his concern regarding efforts to adopt or propose regulatory frameworks for ESG investing. For example, he noted that in 2021, the Department of Labor (DOL) provided mixed messaging regarding changing standards for ERISA fiduciaries. In a prior rule adopted in 2020, the DOL set forth a clear standard that the "evaluation of plan investments must be focused solely on economic considerations that have a material effect on the risk and return of an investment." In 2021, the DOL adopted a revised version of the rule stating that the "risk and return factors may include the economic effects of climate change and other ESG factors." Commissioner Uyeda noted that, while on its face the additional language did not broaden or narrow the scope of "material" factors that ERISA fiduciaries could consider, the DOL issued a press release stating that the new rule "remove[s] barriers to considering [ESG] factors in plan investments," implying that the scope of considerations had been broadened. Similarly, the SEC recently proposed disclosure requirements for entities using

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ESG strategies or names, requiring accurate disclosures about how client assets are invested. Commissioner Uyeda remarked that this could depart from current securities law principals, which require issuers to disclose information that is material to the economics of an investment decision, and could thus lead to the undesirable effect where regulators drive the industry to adapt to ESG-related criteria that could reflect political or social agendas in order to obtain capital, rather than be tied strictly to economic considerations.

3. Activism by asset managers. Commissioner Uyeda observed that asset managers themselves may also have “investment stewardship” initiatives, and use their client proxy voting powers and beneficial ownership of companies’ voting securities to steer companies towards furthering social and political agendas that may not be related to the interests of their clients. Commissioner Uyeda warns that such asset managers would be walking a fine line between hewing to their fiduciary duties to clients and furthering such unrelated social and political agendas.

Conclusion

In conclusion, Commissioner Uyeda remarked that current securities regulatory frameworks already serve investors well by requiring asset managers to clearly explain the nature of their ESG fund or product, with a focus on financial materiality. He warned that emerging ESG regulations should take care not to erode the efficacy of existing regulations by inappropriately tipping the scale in favor of political or social causes.

Litigation

SEC settles charges against investment adviser for alleged conflicts of interest arising out of revenue sharing and incentive arrangements

On January 19, 2023, the SEC issued an order (the Moors & Cabot Order or the Order) instituting and settling administrative and cease-and-desist proceedings against Moors & Cabot, Inc. (Moors & Cabot), a registered investment adviser and broker-dealer with approximately $2.24 billion in assets under management.

The Moors & Cabot Order arises out of Moors & Cabot’s contracts with two third-party broker-dealers that provided or provide clearing and custodial services to Moors & Cabot, “Clearing Broker A” and “Clearing Broker B.” According to the Order, Clearing Broker A provided most Moors & Cabot clients with only one option for a cash sweep account, the “BDS account,” while a limited number of clients could use alternative cash sweep options, “Money Market Fund A” and “Money Market Fund B.”

Revenue sharing arrangements

Moors & Cabot’s arrangement with Clearing Broker A allegedly created incentives for Moors & Cabot to cause investor cash to be invested in the BDS account even if other alternatives were available. Moors & Cabot received a share of Clearing Broker A’s fee income with respect to the BDS account, a smaller share of such income for Money Market Fund A, and no share of fee income for Money Market Fund B. Moors & Cabot also received a $1 per trade discount if Moors & Cabot clients had BDS accounts above certain thresholds.

Moors & Cabot also allegedly received other portions of revenue that Clearing Broker A earned from Moors & Cabot clients. Moors & Cabot allegedly set the margin interest rate for its clients, and received a share of revenue equal to the difference between the rate it set and Clearing Broker A’s cost of funds. Moors & Cabot also had the option to set the rate for “postage and handling fees” charged by Clearing Broker A, and to retain the amount of such fees charged in excess of $2.25 per trade. Moors & Cabot allegedly set this fee at $7.95 per trade (thus earning a $5.70 per trade markup).

In January 2020, Moors & Cabot allegedly switched from Clearing Broker A to Clearing Broker B. Its arrangement with Clearing Broker B also provided for certain revenue sharing. Clearing Broker B also provided several options for cash sweep accounts: a BDS account and, for clients that had at least $1 million in cash, institutional shares of “Money Market Fund C.” Moors & Cabot received a share of fee income from cash held by its clients in BDS accounts, but did not receive a share of such income for cash invested in Money Market Fund C. Moors & Cabot also received certain “incentive credits” in the form of loan forgiveness if Moors & Cabot clients maintained BDS account balances above certain thresholds. Similarly, Moors & Cabot had the authority to set the margin interest rate and to retain the amount of such interest above the base lending rate set by Clearing Broker B.

Alleged disclosure deficiencies

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The SEC alleged that Moors & Cabot failed to adequately disclose the potential conflict of interest arising out of the revenue sharing arrangements. Moors & Cabot disclosed that customer cash in BDS accounts "may" create financial benefits for Moors & Cabot because it received fees; according to the SEC, this failed to disclose that Moors & Cabot did receive actual, not just potential, financial benefits on account of customer cash held in BDS accounts. In addition, the SEC alleged that Moors & Cabot did not disclose that, by default, Moors & Cabot would cause client funds to be swept into the cash sweep option that was less profitable to clients eligible to use other options such as the money market funds. Moors & Cabot also allegedly failed to disclose that it received a share of margin interest revenue, and that it retained a markup on the transaction fee charged by Clearing Broker A.

In addition, Moors & Cabot allegedly failed to adequately disclose its disciplinary history. In its Form ADV, it disclosed that it had "an administrative proceeding before the SEC or a state regulatory agency" that "occurred some time ago," but did not disclose that it included a settlement between Moors & Cabot and FINRA in 2020, and that there were FINRA enforcement proceedings pending against two supervised persons of Moors & Cabot.

The SEC further alleged that Moors & Cabot failed to implement written policies and procedures designed to disclose all material facts in light of the alleged disclosure failures described above.

On account of this alleged misconduct, the SEC asserted that Moors & Cabot violated sections 206(2) and 206(4) of the Advisers Act, and Rule 206(4)-7 thereunder. Moors & Cabot agreed to cease and desist from further violations, to be censured, and to pay disgorgement of $1,436,182, prejudgment interest of $88,274, and a civil money penalty of $875,000. Moors & Cabot also agreed to correct its disclosures and to inform affected clients.

This Order is yet another reminder of the SEC's perennial focus on conflicts of interest, and the importance of disclosing actual and potential conflicts of interest in a manner that clearly communicates the existence of known actual conflicts of interest.

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