Investment Management Regulatory Update

January 29, 2021

Rules and Regulations

IRS Finalizes Carried Interest Regulations

The IRS has issued final regulations on the taxation of carried interest under Section 1061 of the tax code. Section 1061 was added to the tax code as part of the 2017 tax reform legislation and generally provides that capital gain allocated under certain carried interest arrangements is eligible for the favorable 20% U.S. federal income tax rate only if the underlying asset was held for more than three years at the time of sale. Davis Polk has published a **Client Alert** discussing the final regulations.

Industry Update

SEC Division of Examinations Statement on Recent and Upcoming Regulation Best Interest Examinations

On December 21, 2020, the recently renamed Division of Examinations ("**DOE**," formerly the Office of Compliance Inspections and Examinations) released new guidance regarding its upcoming examination program and priorities with respect to Regulation Best Interest ("**Regulation BI**" or the "**Regulation**"), which was adopted on June 5, 2019.

Regulation BI introduced a new, elevated standard of care that requires broker-dealers to act in the best interest of retail customers when making recommendations to such customers. Following the Regulation BI compliance date of June 30, 2020, DOE staff undertook preliminary examinations to determine whether firms had developed and instituted policies and procedures reasonably designed to comply with the procedural and substantive requirements of Regulation BI.

Based on those initial assessments, DOE staff intend to broaden the scope of their Regulation BI examination program in 2021 to (1) focus on the Regulation's specific requirements, particularly those that require broker-dealers to have a reasonable basis to believe that a recommendation is in the best interest of the customer and (2) undertake more rigorous transaction testing to determine whether broker-dealers have effectively implemented their Regulation BI policies and procedures.

Accordingly, DOE staff has advised that the following components of Regulation BI will be prioritized in the next phase of examinations, beginning in January 2021:

- **Continued evaluation of firm policies and procedures**, including evaluating specific firm processes for compliance with Regulation BI, and alterations to firm product offerings (e.g., the removal of higher cost products when lower cost products are available).
- **Evaluation of how firms have considered costs in making a recommendation**, which may include a review of the information that is available to firm personnel to identify relevant costs, how any such information has been used by firm personnel and any documentation relating to the consideration of costs.
- **Evaluation of the processes firm personnel have used to make recommendations to new customers**. As an example, if a firm recommended a rollover from an employee benefit plan, examiners will assess what information was gathered from new customers, what disclosures were made at the time, how alternatives were considered and what documentation was retained.
- **Evaluation of the processes firm personnel have used to recommend complex products**, including a review of the information that was available and used to consider reasonably available alternatives.
- **Evaluation of the processes that firms have used to identify and address conflicts related to recommendations**.

The DOE staff also announced that it will be conducting "enhanced transaction testing" to determine whether broker-dealers have effectively implemented their written policies and procedures. Given this guidance, DOE staff encourages broker-dealers to evaluate their processes and practices, "in particular, to consider whether the initial programs adopted by the June 30, 2020 compliance date are, in practice, reasonably designed to achieve compliance with Regulation Best Interest."

- **See a copy of the statement**

SEC Staff ADI Statement on Registered Funds' Risk Disclosure Regarding Investments in Emerging Markets

On December 14, 2020, the Division of Investment Management's Disclosure Review and Accounting Office ("**DRAO**") issued an ADI summarizing information gathered on the risk disclosures of funds with significant exposure to emerging markets.

The Findings

DRAO observed that a significant amount of U.S. investor exposure to emerging markets comes from funds investing in emerging markets. DRAO noted that the availability and reliability of material financial information from companies in these markets may be limited in comparison to the scope and reliability of financial information provided by U.S. companies. For instance, in many emerging markets, there is significantly less publicly available information about companies due to differences in reporting and recordkeeping standards. Likewise, in some markets, differences in organizational structures may limit investor rights and recourse. With this being said, DRAO has reviewed the filings of funds that invest in emerging markets and encourages funds to provide tailored disclosures of emerging markets risks so that investors may make informed investment decisions. DRAO noted that funds should consider the following factors when drafting risk disclosures:

- risks related to, but not limited to, lack of liquidity, market manipulation concerns, limited reliable access to capital, political risk, and foreign investment structures;
- whether and how emerging markets risks arising from differences in regulatory, accounting, auditing, and financial reporting and recordkeeping standards could impede an adviser's ability to evaluate local companies or impact the fund's performance;

- any limitations on the rights and remedies available to the fund, individually or in combination with other shareholders, against portfolio companies;
- if an index fund, whether the index provider will have less reliable or current information–e.g., due to issues associated with the regulatory, accounting, auditing, and financial reporting and recordkeeping standards in the relevant emerging market–when assessing if a company should be included in an index or determining a company's weighting within the index;
- if an index fund, any limitations concerning the adviser's ability to assess the index provider's due diligence process over index data prior to its use in index computation, construction and/or rebalancing; and
- whether the limitations stated above could impact the stated investment objective of the fund.

DRAO encouraged funds investing in emerging markets to consider whether they have "adequate risk disclosure about the unique risks and uncertainties that companies with significant operations in emerging markets often face" and noted that "boilerplate disclosures generally are not useful or sufficient in these circumstances."

- **See a copy of the statement**

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

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