Investment Management Regulatory Update

November 24, 2020

COVID-19 Update

Please refer to Davis Polk's "**Coronavirus Updates**" webpage for content related to the outbreak.

Rules and Regulations

SEC Simplifies Private Offering Rules

Earlier this month, the Securities and Exchange Commission ("**SEC**") adopted broad changes to the current framework of private offerings. Recognizing the growing availability and appeal of private investments, this is the latest in a series of recent actions by the SEC (including expanding "testing the waters" communications and adding new categories of accredited investors) intended to broaden access to capital markets for issuers and to the exempt offering market for investors. The new rules are substantially similar to those proposed in March 2020 and incorporate a number of comments received by the SEC from Davis Polk and others, such as the inclusion of bright-line rules. For further information, please see Davis Polk's **Client Memorandum** discussing the new rules.

Withdrawal of SEC Staff No-Action Letters Related to Rulemaking on Funds of Funds and ETFs

On October 28, 2020, the staff of the SEC's Division of Investment Management (the "**Staff**") issued an information update (the "**October Update**") regarding its withdrawal of twelve no-action letters previously issued and related to the regulation of funds which invest in other funds. According to the October Update, the Staff's withdrawal of the no-action letters is consistent with the SEC's adoption of rule 12d1-4 under the Investment Company Act of 1940, as amended (the "**Investment Company Act**") on October 7, 2020—a rule which is aimed at streamlining and enhancing the regulatory framework applicable to funds of funds. The October Update noted that the date of withdrawal of the no-action letters is one year from the effective date of Rule 12d1-4.

Separately, on November 6, 2020, the Staff issued an information update (the "**November Update**") regarding its withdrawal of four no-action letters previously issued and related to the regulation of exchange-traded funds ("**ETFs**"). According to the November Update, the Staff's withdrawal of the no-action letters is consistent with the new rule and form amendments adopted by the SEC on September 25, 2019 that were designed to modernize the regulation of ETFs. The November Update noted that the date of withdrawal of the no-action letters is December 23, 2020.

A complete list of the withdrawn letters in the October Update and November Update can be found at the links below.

- **See the October Update**
- **See the November Update**

Industry Update

OCIE Issues Risk Alert on Observations from Examinations of Investment Advisers with Multiple Branch Offices

On November 9, 2020, the Office of Compliance Inspections and Examinations ("**OCIE**") issued a risk alert to share observations from its examinations of SEC-registered investment advisers operating from multiple branch offices geographically dispersed from the adviser's principal or main office. According to the risk alert, the examinations focused on the compliance and supervisory practices of advisers' main office and its oversight of its branch offices, including: (i) compliance with certain rules, such as the code of ethics and custody rules of the Investment Advisers Act of 1940, as amended (the "**Advisers Act**"), and (ii) consistency with fiduciary obligations, such as those related to fees, expenses, and advertising. The examinations also focused on the processes by which advisory personnel in the advisers' branch offices provide investment advice to advisory clients, including: (i) oversight of investment recommendations across advisers' branch offices, (ii) management and disclosure of conflicts, and (iii) allocation of investment opportunities.

The risk alert noted that the examinations were conducted on approximately 40 advisers, most of which conducted business out of 10 or more branch offices, primarily with retail clients. OCIE staff noted that the branch office model may present heightened compliance risks because "geographically dispersed personnel may develop different practices or disparate ways of communicating." Among other things, the risk alert highlighted the following issues observed by OCIE staff from such examinations.

Compliance and Supervision

OCIE observed that the vast majority of examined advisers had at least one deficiency relating to Rule 206(4)-7 under the Advisers Act with respect to the advisers' compliance programs. According to the risk alert, more than half of these advisers had compliance policies and procedures that were (i) inaccurate because they contained outdated information; (ii) inadequately implemented because the compliance department failed to collect the records required under the policies; (iii) applied inconsistently in branch offices or (iv) not enforced. Specifically, OCIE noticed deficiencies in the following areas:

- *Custody of client assets* – Advisers did not have policies and procedures that limited the ability of supervised persons to process withdrawals and deposits in client accounts, change client addresses of record, or do both.
- *Fees and expenses* – Advisers did not have policies and procedures to identify and remediate instances where undisclosed fees were charged to clients. OCIE staff noted that lack of oversight over fee billing processes sometimes resulted in overcharges to clients.
- *Oversight and supervision* – OCIE staff noted that supervision deficiencies were prevalent with respect to oversight of branch office personnel with higher risk profiles, such as identification and

documentation of disciplinary events. Other deficiencies included those related to disclosure of material information regarding disciplinary events, portfolio management and best execution.

- *Advertising* – OCIE staff observed deficiencies in advertising materials, particularly in materials prepared by supervised persons of advisers operating under a different "doing business as" name from the advisers' primary name, including: performance presentations that omitted material disclosures, superlatives and unsupported claims, false statements of professional experience and credentials of supervised persons, and references to rakings and awards that omitted material facts.
- *Code of Ethics* – OCIE staff observed omissions from advisers' code of ethics, such as omission of review and approval procedures before investing in limited or private offerings, and requirements for submission of initial and annual personal holdings reports and quarterly transactions reports.

Investment Advice

With respect to investment advice, OCIE noted that more than half of the examined advisers had deficiencies related to portfolio management practices. According to the risk alert, the deficiencies often related to:

- *Oversight of investment decisions occurring within branch offices* – Deficiencies noted by OCIE staff often related to mutual fund share class selection practices and disclosures, and recommendations and disclosures related to wrap fee programs. OCIE staff also noted that automated rebalancing of client accounts caused certain clients to incur short-term redemption fees for mutual fund products, and certain advisers did not consider whether such automated processes were in the best interest of clients.
- *Conflicts of interest* – OCIE staff noted failures to fully and fairly disclose conflicts relating to expense allocations that seemed to benefit proprietary fund clients over non-proprietary fund clients, and financial incentives for advisers to recommend specific products.
- *Trading and allocation of investment opportunities* – OCIE staff observed deficiencies in documentation reflecting advisers' analysis regarding best execution; principal transactions involving securities from advisers' inventories without prior client consent; and inadequate monitoring of supervised persons' trading practices.

Firms' Compliance Policies

OCIE observed a range of compliance practices that may be helpful to advisers in designing compliance oversight programs with respect to multiple branch locations. Examples of such practices include:

- Compliance policies and procedures that "(1) were applicable to all office locations and all supervised persons – regardless of whether these individuals were independent contractors or employees of the adviser; (2) include unique aspects associated with individual branch offices; and (3) specifically address compliance practices necessary for effective branch office oversight." Examples include:
  - Uniform policies and procedures for main office oversight regarding monitoring and approving advertising;
  - Centralized, uniform processes to manage client fee billing;
  - Centralized process for monitoring and approving personal trading activities for all supervised persons in all office locations; and

- Uniform portfolio management policies and procedures and/or portfolio management systems across all office locations.

- Compliance testing or periodic review of key activities at all office locations at least annually or more frequently.
- Compliance policies and procedures to check for prior disciplinary events during the hiring process and to confirm periodically the accuracy of disclosures relating to such information.
- Required compliance training of branch office employees semiannually or at least annually.

Conclusion

In the risk alert, OCIE encouraged firms to review their current policies and procedures, to consider the unique risks and challenges of operating a business model with numerous branch offices and geographically dispersed business operations, and to adopt policies and procedures to address such risks and challenges.

- **See a copy of the Risk Alert**

SEC Division of Investment Management Chief Accountant's Office Issues "Dear CFO" Letter

On October 23, 2020, the SEC Division of Investment Management Chief Accountant's Office (the "**Staff**") issued **new "Dear CFO Letters"** directed towards an intended audience of chief financial officers and independent public accountants to provide updated guidance regarding accounting and auditing-related disclosure requirements. A summary of the rescinded, modified or new positions cited in the Dear CFO Letters is included below and may also be accessed in the **Accounting Matters Bibliography** available on the SEC's website.

New Guidance

- The Staff expressed a new position on the commencement of operations date (IM-DCFO 2020-01). The date a fund commences operations may be different for purposes of financial reporting and performance calculations, and the Staff stated that it would not recommend enforcement action if a fund calculates its standardized average annual total return from the date that the fund commenced investment operations, if that date follows the date of effectiveness of the fund's registration statement. In such case, the Staff also stated it would not recommend enforcement action if the fund omits certain statements or schedules from its financial statements until investment operations have begun.
- The Staff also issued new guidance providing that certain business development companies (each a "**BDC**") may be permitted to include limited financial statements in their initial registration statements filed on Form N-2 or Form 10, if the BDCs have only received seed capital and/or have only incurred organization and offering expenses as of the financial statement date (IM-DCFO 2020-02).
- The Staff provided new guidance regarding registered investment advisers' ("**RIAs**") reliance on the "audit exception" under the Advisers Act custody rule when combining audited financial statements of multiple related limited partnerships or other pooled investment vehicles ("**PIVs**"). (IM-DCFO 2020-03). The Staff noted in the guidance that it believes that if an RIA uses combined financial statements to rely on the audit exception under the custody rule, the RIA should consider, among other things, whether:
  - each PIV has the same management;

- there is clear evidence of legal ownership of each investment individually with each PIV or there are contractual agreements which clearly show the assignment of investments held on a combined basis to each PIV;
- investments and investment gains and losses, including income and expenses, are allocated pro rata to each PIV;
- each PIV has the same management fee and performance fee structure (e.g., allocations work on a combined basis, calculated based on one hurdle on the combined basis, including combined fair values and contributions/distributions);
- the financial highlights are the same for each PIV; and
- the combined financial statements will:
  - present a statement of changes for each PIV separately and a combined aggregate total; and
  - provide clear disclosure of each PIV's pro rata percentage ownership of the combined basis, total commitments of each PIV, and aggregated commitments on a combined basis.

Modified Guidance

- The Staff modified its prior guidance with respect to the senior securities table audit requirement (IM-DCFO 2001-02) for BDCs and closed-end funds ("**CEFs**"), as a result of changes to the offering disclosure requirements for such funds through BDC and CEF offering reforms.
- The Staff further modified its previous guidance regarding the requirements for reporting a change in auditor (IM-DCFO 1998-04) to make reference to Form N-3 as well as the requirement pursuant to Regulation S-K that the former auditor furnish a letter to the SEC regarding its concurrence with certain statements made by the registrant.

Rescinded Guidance

- The Staff rescinded its prior guidance regarding the disclosure of the average commission rate in prospectuses and shareholder reports of CEFs (IM-DCFO 1998-01), which is no longer required as a result of BDC and CEF offering reforms.

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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