Investment Services Regulatory Update

August 2021

Monthly Version

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RISK ALERTS

Division of Examinations Cautions Advisers on Compliance Deficiencies with Fixed Income and Principal Cross Trades

On July 21, 2021, the SEC's Division of Examinations issued a Risk Alert highlighting compliance deficiencies observed by the staff during an examination initiative focusing on investment advisers engaged in fixed income cross trades and principal trades—referred to by the staff as the "FIX Initiative." The FIX Initiative involved over 20 examinations of advisers that collectively managed approximately $2 trillion in assets for over two million client accounts, including more than 1 million retail clients, nearly 3,000 pension and profit sharing plans and over 150 mutual funds. Focus areas for the SEC staff during the FIX Initiative included: (1) conflicts of interest; (2) compliance programs; and (3) disclosures.

The deficiencies observed by the SEC staff included the following:

- **Policies and procedures were inconsistent with adviser practices, disclosures and/or regulatory requirements.** For instance, the SEC staff noted compliance programs that did not include specific procedures to confirm whether principal trades, cross trades or both were completed in a manner consistent with the advisers' disclosures to clients and their policies and procedures, or whether appropriate consent was received from, and disclosure provided to, the involved clients prior to completing the transactions.
- **Policies and procedures lacked certain considerations or guidance, such that the examined advisers' personnel did not have the full scope of information that may be necessary to achieve compliance.** For example, the SEC staff observed advisers that did not specify in their procedures the factors advisory personnel should consider in seeking to determine that trades were in the best interests of clients, as well as advisers that did not include a section in their cross trading reporting forms to document why trades were considered to be in the best interests of the participating clients.
- **Policies and procedures were not effectively tested.** Many examined advisers did not effectively test the implementation of their written compliance policies and procedures for principal and cross trades, such as by analyzing their trade blotters to identify unreported principal and cross trades. Consequently, the SEC staff observed that advisers, including firms that prohibited cross trades, were unaware that these trades had occurred.
- **Unidentified or unaddressed conflicts of interest.** For example, the SEC staff noted cross trades that were subject to markups or other fees that were not fully disclosed. In other instances, the SEC staff noted cross trades that were not executed at independent market prices and did not use best price and best execution efforts, resulting in participating clients receiving an unfair price for the securities.
- **Written disclosure deficiencies.** For example, the SEC staff noted that advisers omitted certain relevant information concerning cross trading activities in their Forms ADV or had no disclosures regarding the conflicts of interest associated with executing such trades in Part 2A of their Forms ADV.

In addition to the foregoing deficiencies, the Risk Alert includes the staff's observations as to certain industry practices that may help firms address some of the areas of noncompliance.

The Risk Alert encourages advisers to review their written policies and procedures regarding principal and cross

trades, including the implementation of those policies and procedures, to ensure that they are consistent with regulatory requirements.

The Risk Alert is available here.

Division of Examinations Risk Alert Identifies Common Deficient Practices with Wrap Fee Programs

On July 21, 2021, the SEC's Division of Examinations issued a Risk Alert identifying the most frequently cited deficiencies in adviser compliance programs from the staff's Wrap Fee Initiative. The Division's Wrap Fee Initiative involved over 100 examinations of advisers, including firms that serve as portfolio managers in, or sponsors of, wrap fee programs and firms that advise their clients' accounts through one or more unaffiliated third-party wrap fee programs. Noting that "many examined advisers' compliance programs could be improved," the most frequently cited deficiencies related to: (1) compliance and oversight, including policies and procedures for monitoring wrap fee programs; and (2) disclosures, including disclosures regarding conflicts, fees and expenses.

The deficiencies observed by the SEC staff included the following:

- **Failure to monitor trading in clients' accounts or ineffective monitoring.** The SEC staff noted advisers that failed to monitor for "trading-away" from the broker-dealers providing bundled brokerage services to the wrap fee programs and the associated costs of such trading-away practices. Consequently, clients may have incurred transaction costs in addition to paying the bundled wrap fees. The staff also identified infrequent trading in wrap fee accounts at several examined advisers, suggesting that certain clients with low trading activity were paying higher total fees and costs than they would incur in non-wrap fee accounts.
- **Failure to assess whether wrap fee programs were in the clients' best interests.** The SEC staff noted advisers that routinely recommended participation in wrap fee programs without conducting assessments—initially, ongoing or both—as to whether the programs were in the clients' best interests. Other advisers conducted inadequate ongoing reviews, such as assessments limited to a small sampling of accounts or that systematically excluded certain transferred and/or legacy accounts.
- **Inconsistent or misleading disclosures regarding the same topic in various documents.** For instance, the SEC staff noted advisory agreements that indicated clients would pay brokerage commissions even though wrap fee program brochures expressly stated that clients would not pay such fees. Other advisers disclosed householding discounts and other rebates that were not applied, resulting in clients being overbilled.
- **Omitted disclosures or inadequately described conflicts of interest.** For example, the SEC staff noted advisers that did not disclose that client accounts with low trading volumes, high cash balances or significant fixed income weightings may be able to receive similar services at a lower cost outside of a wrap fee program.
- **Weak, ineffective or nonexistent compliance policies and procedures relating to wrap fee programs.** For example, the SEC staff noted advisers that failed to fully implement or enforce their compliance policies and procedures, such as by failing to: (1) conduct due diligence on third-party portfolio managers they recommended to clients, despite statements made otherwise; (2) review client accounts and fee billing as outlined in the policies; (3) implement policies, as stated, related to best interest reviews, advertising, code of ethics; and (4) ensure that disclosure documents were current.

In addition to the foregoing deficiencies, the Risk Alert includes the staff's observations as to certain industry practices that may help firms address some of the areas of noncompliance.

The Risk Alert includes the following recommendations to advisers regarding wrap fee programs:

- Conduct reviews of wrap fee programs—both initially and periodically thereafter—to assess whether the programs are in the best interests of clients, with information obtained directly from clients, such as through interviews, discussions and/or questionnaires.
- Periodically remind clients, after conducting initial best interest reviews associated with the recommendation to participate in wrap fee programs, to report any changes to their personal situations, or financial standing or needs, and investment objectives that might impact the clients' risk tolerances, investment allocations and/or recommended investments.
- Communicate with clients to prepare and educate them when recommending that accounts convert from non-wrap fee accounts to wrap fee programs.
- Provide clients with disclosures about conflicts of interest related to transactions executed within the wrap fee programs.
- Provide clear disclosures, when recommending wrap fee programs to clients, about whether certain services or expenses are or are not included in the wrap fee.
- Include within compliance policies and procedures factors to be used when assessing whether investment recommendations made to clients participating in wrap fee programs, including asset allocations and selection of managers, are in the clients' best interests.
- Monitor and validate that best execution is being sought for wrap fee clients.
- Identify what the adviser considers to be "infrequently" traded accounts and ensure that such accounts are reviewed to ensure that a wrap fee program remains in the client's best interests.

The Risk Alert is available here.

OTHER DEVELOPMENTS

SEC Raises Qualified Client Thresholds

Effective August 16, 2021, there are new financial thresholds for determining whether an investor of a registered investment adviser (RIA) is a "qualified client" pursuant to Rule 205-3 under the Investment Advisers Act of 1940, and can thus be charged performance-based fees. The assets-under-management test will increase from $1,000,000 to $1,100,000 and the net worth test will increase from $2,100,000 to $2,200,000.

The SEC issued an order on June 17, 2021 describing these changes and the reasoning therefor.

The increases to the financial thresholds are required by the Dodd-Frank Wall Street Reform and Consumer Protection Act, which amended Section 205(e) of the Advisers Act to provide that every five years beginning on July 21, 2011 the SEC must adjust these threshold amounts to account for inflation by rounding to the nearest multiple of $100,000 based on the Personal Consumption Expenditures Chain-Type Price Index published by the U.S. Department of Commerce.

The increased threshold amounts apply to new investors and to existing investors that are making new commitments, but are not retroactive, so that advisory agreements entered into before August 16, 2021 need not be amended. However, any new or existing private funds (that are still accepting new commitments) will need to revise their offering documents, subscription agreements, and advisory agreements to reflect the new thresholds.

The SEC's order is available here.

Citing "Greenwashing" Concerns, IOSCO Issues Recommendations to Securities Regulators on Sustainability-Related Practices, Policies and Disclosures

On June 30, 2021, the International Organization of Securities Commissions (IOSCO)—which counts the SEC among its members—issued a consultation report recommending that securities regulators set regulatory and supervisory expectations for asset managers regarding sustainability-related risks and opportunities.

IOSCO's recommendations to securities regulators covered five areas:

1. **Asset Manager Practices, Policies, Procedures and Disclosures.** Set regulatory and supervisory expectations for asset managers with respect to sustainability-related practices, policies, procedures and disclosures.
2. **Product Disclosure.** Clarify and/or expand existing regulatory requirements or create new regulatory requirements to improve sustainability-related product disclosure.
3. **Supervision and Enforcement.** Adopt supervisory and enforcement tools to ensure asset managers and sustainability-related products comply with regulatory requirements and to address breaches.
4. **Terminology**. Encourage industry participants to develop common sustainability-related terminology to ensure consistency in the asset management industry.
5. **Financial and Investor Education.** Promote financial and investor education initiatives relating to sustainability and enhance existing initiatives.

The foregoing recommendations are intended to address IOSCO's concerns regarding "greenwashing," among other things. Greenwashing generally refers to the practice by asset managers of misrepresenting their own sustainability-related practices or the sustainability-related features of their investment products. IOSCO's report emphasized the investor protection-related concerns with greenwashing given the significant growth in the market for sustainability-related investment products.

The Board of IOSCO invited market participants and interested parties to submit comments on the report on or before August 15, 2021.

IOSCO's consultation report is available here.

SEC Office of the Investor Advocate Issues Annual Report on Objectives for 2022 Fiscal Year

On June 28, 2021, the SEC's Office of the Investor Advocate (OIA) issued its annual report on objectives for the 2022 fiscal year. The OIA is tasked with, among other things, identifying problems investors have with financial service providers and products and areas in which investors would benefit from changes in financial regulations. The OIA focuses on reviewing SEC and relevant self-regulatory organization rulemaking but prioritizes certain issues to maximize its impact for investors. Among other things, the annual report outlines the following areas of focus for the 2022 fiscal year:

- **Environmental, Social and Governance (ESG) Disclosure.** Noting increased investor and regulatory interest in ESG matters, OIA favors a balance of prescriptive and principles-based ESG disclosure requirements, in particular with respect to ESG-related risk disclosure, to promote comparability to the extent possible, particularly with respect to required disclosures of objective facts.
- **Rule 10b5-1 Plans.** Rule 10b5-1 Plans, which allow insiders to trade during blackout periods without violating insider-trading laws, have come under scrutiny following evidence that some executives may have misused such plans to effectively trade on the basis of

material non-public information. OIA proposes to study the rule and its application to assess, among other things, whether trading under to these plans should be paused during a set "cooling off" period, or whether companies or their executives should be required to disclose plan details.

- **Capital-Raising Alternatives.** OIA will study whether investors receive adequate disclosures with respect to certain novel capital-raising methods, such as direct listings and special purpose acquisition companies (SPACs), and whether such methods implicate other investor-protection considerations. In particular, OIA will work with the SEC to assess whether SPAC investors would benefit from additional guidance, regulatory changes or clarification on the scope of the relevant securities laws.
- **Equity Market Structure.** OIA intends to continue engagement on initiatives related to: (1) shortening the current two-day security settlement period in U.S. financial markets; (2) pilot programs for thinly traded securities to explore the effects of restricting unlisted trading privileges; (3) enhancing rules governing transfer agents; (4) studying and addressing potential conflicts of interest relating to payments of exchange fees and rebates in connection with broker-dealer order routing behavior as well as the impact of payments for order flow by market makers when broker-dealers route orders off exchanges; and (5) enhancing transparency in short selling and the related practices of stock lending and borrowing.
- **Novel Exchange-Traded Funds (ETFs).** OIA will maintain a focus on whether non-transparent ETFs are functioning as intended and will monitor developments related to leveraged and inverse ETFs, specifically regarding the application of new Rule 18f-4 (the Derivatives Rule) to those ETFs.
- **Registered Fund Disclosure.** OIA will continue to help the SEC develop effective and efficient disclosure regulations by using surveys, focus groups and other methods to gather information regarding investor behavior and to provide data on disclosure-related policy choices.
- **Cryptocurrency.** Noting recent developments and regulatory statements in the cryptocurrency area, OIA will continue to monitor matters regarding cryptocurrencies, including pending applications for cryptocurrency-focused ETFs, to help investors access new investment opportunities while maintaining appropriate investor protections. OIA cited custody issues associated with digital assets and unregulated trading platforms as the most significant obstacles to the launch of a well-regulated cryptocurrency ETF.
- **Broker Conduct.** OIA highlighted two issues relevant to broker-dealer conduct: (1) the SEC's recently adopted "best interest" standard of conduct for recommendations under Regulation BI and (2) broker migration and misconduct. Among other things, OIA encourages regulators, such as the SEC and FINRA, to consider whether the structure of online-only broker-dealers could constitute a recommendation under Regulation BI and to continue to enforce regulations designed to protect investors against bad actors.
- **Financial Exploitation of Senior Investors.** OIA advocates for investor protections for vulnerable investors, including seniors, and will work with the SEC to better understand and support senior investors.

The report also contains a summary of the services and activities of the Ombudsman, who acts as a liaison between the SEC and any retail investor to resolve problems that retail investor may have with the SEC or any self-regulatory organization, reviews and recommends policies and procedures to encourage dialogue with the OIA regarding securities law compliance and establishes safeguards to maintain the confidentiality of communications between investors and the Ombudsman. In addition, the report includes a summary of the recommendations of the Investor Advisory Committee (IAC), which is supported by the OIA, and the SEC's responses during the preceding fiscal year.

The complete OIA Report is available here.

Litigation and Enforcement Matters

LITIGATION MATTERS

Tenth Circuit Court of Appeals Affirms District Court's Judgment for Great-West in Section 36(b) Excessive Fee Suit

On July 26, 2021, the U.S. Court of Appeals for the Tenth Circuit affirmed the decision of the U.S. District Court for the District of Colorado in favor of defendants Great-West Capital Management, LLC and Great-West Life & Annuity Insurance Co. (together, Great-West) in a Section 36(b) excessive fee case.

On August 7, 2020, after an 11-day bench trial, the District Court issued a judgment in favor of Great-West, holding that the plaintiffs failed to prove that Great-West breached its fiduciary duties under Section 36(b) of the Investment Company Act of 1940 by charging excessive fees. Citing, among other things, that the testimony of the plaintiffs' four fact witnesses had limited probative value and that plaintiffs' sole expert witness was non-credible, the District Court found that the plaintiffs failed to meet their burden of proof with respect to each of the factors prescribed in *Gartenberg v. Merrill Lynch Asset Management, Inc.,* and the plaintiffs failed to identify any legitimate damages stemming from Great-West's alleged breach.

On appeal, the Tenth Circuit reviewed the District Court's factual findings for clear error, and its legal conclusions *de novo*. Because the District Court ruled in favor of Great-West on each *Gartenberg* factor, and because, as the Tenth Circuit stated, "no single factor is dispositive" of excessive fees, plaintiffs had the burden to convince the Court that the District Court erred with respect to its assessment of multiple *Gartenberg* factors. The Tenth Circuit found that the District Court did nor err on any factor, stating that because the "record is so flush with support for the district court's factual findings" the plaintiffs were "left with little recourse beyond relitigating facts decided in district court." The Tenth Circuit noted that the plaintiffs also failed to satisfy their burden under Section 36(b), as they did not present evidence to establish an outer bound for a fee that may be bargained for at arm's length or that Great-West's fees were beyond that outer bound.

In its opinion, the Tenth Circuit emphasized the importance of the sixth *Gartenberg* factor—"the level of expertise, conscientiousness, independence, and information with which the board acts"—stating that prior judicial treatment of this factor, including by the U.S. Supreme Court in *Jones v. Harris Associates, L.P.,* and its "unique basis in the statutory text" suggest that this factor is of prime importance in the consideration of Section 36(b) cases. The Tenth Circuit discussed at length the contract review process undertaken by the board of the Great-West funds, noting testimony that the board was highly engaged in the process and that the board's process followed best practices recommended by industry authorities. The Tenth Circuit noted that the board's independent members were represented by outside legal counsel who advised them regarding the information they should consider, whether the information received from Great-West was sufficient for them to make an informed decision and how they should apply the *Gartenberg* factors in analyzing that information. The Tenth Circuit further noted that the independent board members asked counsel to request additional information from Great-West regarding certain funds' fees and expenses. The Tenth Circuit cited the District Court's findings that the board engaged in a "robust push and pull process" with Great-West, closely scrutinizing the fees Great-West charged to the funds, which resulted in "numerous fee reductions," and that the board members were independent and well-qualified. Accordingly, the Tenth Circuit concluded that the board's decision to approve the funds' fees should be granted substantial deference.

The Tenth Circuit's opinion was issued under the caption *Obeslo, et al. v. Great-Western Life & Annuity, et al.* (No. 20-1310).

Public Statements, Press Releases and Testimony

SEC Chair Gary Gensler Provides Remarks on Crypto Assets at the Aspen Security Forum

On August 3, 2021, SEC Chair Gary Gensler provided remarks on the current state of U.S. crypto asset regulation at the Aspen Security Forum. While acknowledging the contributions crypto assets and blockchain technology have made to financial and monetary innovation, Mr. Gensler noted the immediate need for investor protection in light of the hype, fraud, scams and abuses in the crypto asset space that have resulted in harm to investors.

Mr. Gensler remarked on the protections that exiting U.S. securities laws provide, particularly with respect to initial coin offerings, many of which have been subject to SEC enforcement action as offerings of unregistered securities. Nevertheless, he warned that significant investor protection gaps exist with respect to foreign crypto trading platforms and decentralized finance platforms that purport to prohibit U.S. investors, but through which unregulated trading by U.S. investors is possible. He expressed further concerns about "stablecoins," crypto assets whose value is pegged to a reference asset, typically a currency such as the U.S. dollar, noting the potential use of such assets to evade public policy goals such as anti-money laundering, tax compliance and sanctions, and suggesting that some stablecoins may need to be registered both as securities and as investment companies.

Although brief, Mr. Gensler's remarks about investment vehicles providing exposure to crypto assets were significant. He noted that products providing exposure to crypto assets have been around for several years and that there are a number of mutual funds that invest in Bitcoin futures that trade on the Chicago Mercantile Exchange (CME). In light of the significant investor protections provided by the Investment Company Act, Mr. Gensler stated that he looked forward to the staff's review of filings to offer cryptocurrency-related ETFs, particularly those investing in CME Bitcoin futures.

Mr. Gensler concluded his remarks by stressing that, although some aspects of crypto asset regulation are clear, further Congressional action is needed to close regulatory gaps with respect to crypto transactions, products and platforms. He noted the importance of such crypto asset regulation not only to protect investors but also to encourage innovation and protect national security.

Mr. Gensler's remarks are available here.

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Investment Services Group

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