

The background of the slide is a photograph of a modern glass skyscraper. A vertical yellow bar is on the left side. The Mayer Brown logo is in the top left. The text '15th Annual Investment Management Regulatory University' is centered in white, and 'WEBINAR SERIES' is below it. The date 'September 2, 2021' is in the bottom right, and the title 'Hot Topics in Investment Adviser Regulation' is at the bottom center.

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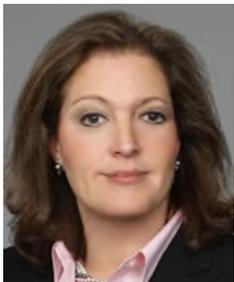
# Investment Management Regulatory University

WEBINAR SERIES

September 2, 2021

## Hot Topics in Investment Adviser Regulation

# Speakers



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# Investment Advice Exemption- Prohibited Transaction Exemption 2020-02

## History and Rationale of the Exemption

### Covered Transactions

- Broad relief for the receipt of compensation for investment professionals in connection with non-discretionary investment advice, including rollover recommendations. This includes the sale of proprietary investment products.
- Relief for receipt of a mark-up, mark-down, or other payment in connection with riskless principal transaction and certain “covered principal transactions”



# Investment Advice Exemption

- Exclusions
- In-house Plans of Financial Institutions
- “Pure” Robo-advice
- Discretionary Management Transactions



# Investment Advice Exemption

- Compliance with Impartial Conduct Standards
- Disclosure
- Policies and Procedures
- Annual Retrospective Review
- Loss of Exemption upon Criminal Conviction, Non-compliance Findings by DOL
- Recordkeeping
- Self-Correction Opportunity



# Investment Advice Exemption

- DOL anticipates taking further action on investment advice, which may include:
  - Issuing a new regulation defining investment advice
  - Amending PTE 2020-02
  - Amending or revoking other commonly used exemptions



# Cybersecurity

- On April 14<sup>th</sup>, the Labor Department provided new guidance including Tips for Hiring a Service Provider with Strong Cybersecurity Practices, Cybersecurity Program Best Practices and Online Security Tips for Participants and Beneficiaries
- The tips include steps that plan fiduciaries may take when diligencing and contracting with service providers, including asset managers. Managers may be asked the following questions:
  - How does the program compare to industry standards?
  - Does the manager engage a third-party auditor to annually review and validate its cybersecurity program?
  - What types of insurance policies does the manager maintain?



# Cybersecurity

- Managers may also be required to provide adequate notice of a breach and may be required to investigate and reasonably address the cause of the breach
- The Labor Department has recently said they are keen on finding out to what extent plan fiduciaries are complying with their guidance and it has become the latest investigation priority.
- Plan fiduciaries should also incorporate the items in “Cybersecurity Program Best Practices” into future service providers requests for proposals



# ESG Overview

- 40 years of sub-regulatory guidance
- Broad principles are consistent
- Details vacillate depending upon the administration
- Trump Administration goal of clarifying the rules
- Skepticism of ESG investing
- Desire to codify the rules into a regulation



# Trump Administration: Financial Factors Rule

- Amending ERISA's investment duties regulation, the Financial Factors or ESG rule requires that fiduciaries evaluate investment opportunities solely upon pecuniary factors
- Non-pecuniary factors may be used as a tie-breaker but the rule includes a burdensome documentation requirement
- ESG funds are not permitted as QDIAs



# Biden Administration

- On May 20, 2021, the Biden Administration issued an Executive Order entitled “Climate-Related Financial Risks”.
- Directs Secretary of Labor to consider rescinding or revising the Trump Administration rules that prohibit ERISA fiduciaries from considering ESG factors in making plan investment decisions
- Deadline is September 2021

A photograph of the SEC building, a modern glass skyscraper with a curved facade, reflecting the sky and clouds. Two flags are visible on poles in front of the building. The image is partially obscured by a teal header bar on the left side.

# SEC Priorities

- ESG Initiatives
  - Division of Examinations Risk Alert and 2021 Examination Priorities
  - Enforcement Task Force
- Regulatory Agenda
- Asset Management Advisory Committee Recommendations
  - ESG
  - Diversity
- Recent Enforcement Actions

# Expense and Investment Allocation Conflicts and SEC Concerns

- I. SEC has historically focused on investment and expense allocations in exams. Concerns have included:
  - Allocation of deals to vehicles with higher fees
  - Allocation of deals to affiliated vehicles
  - Allocation of expenses on a basis that isn't fair and equitable, e.g., on a basis which is non-pro rata
  - Allocation of expenses that have been traditionally paid by the Sponsor
- II. Failure to properly disclose allocations
  - KKR failure to properly disclose allocation of broken deal expenses away from affiliated vehicles

# Expense and Investment Allocation Conflicts and SEC Concerns (con't)

- III. Expense and allocation disclosure and covenants may be in the following documents all of which need to work together
  - ADVs
  - PPMs (both allocation mechanic and the potential for conflicts)
  - LPAs (give consideration to whether some vehicles have priority over other vehicles)
  - Compliance Manuals
  - Side letters
- IV. Recent trends in co-investment vehicles

# Expense and Investment Allocation Conflicts and SEC Concerns (con't)

## V. Drafting tips for allocation disclosures

- Generally good to allocate pro rata as modified on an “equitable basis” by the Sponsor
- Assuming no fees that are traditionally borne by the Sponsor are being shifted to the investors it is generally a good idea to make a general statement that “ordinary overhead” will be paid by the Sponsor
- Likewise, it is good to have a catch-all that states that “all other expenses that relate to activities of the fund” will be borne by the fund



# SEC Regulatory

- SEC Regulatory Flex Agenda – 49 Items, including
  - Rule 10b5-1 Plans
  - Climate Change Disclosure and Investment Company/Investment Adviser ESG Claims
  - SPACs
  - Amendments to Custody Rule
  - Form PF
  - Rule 17a-7 Amendments
  - Money Market Fund Reforms
  - Pay vs. Performance
  - Proxy Voting Advice



# Division of Examinations

- Division of Examinations – It Grew-some, now a full Division
  - Change in Tone
  - 10 Risk Alerts in the last year
  - 2000 Deficiency Letters in 2020
  - Division verifies existence of Assets with Custodians
  - Custody remains Top Priority
  - Fee Miscalculations



# Division of Examinations (con't)

- Enforcement Referrals (130 last year) involving, among others, higher cost mutual fund shares, failure to disclose conflicts of interest, fraudulent inflation of NAV and performance results of managed funds, violations of the custody rule
- Enhancing Event and Emerging Risk Examination Team (EERT)
- Raising importance of supervision, especially with continued remote work environment
- Priorities remain on retail investors, teachers, seniors, military, retirement savers



# Division of Examinations (con't)

- Standards of Conduct, including Regulation BI, RIA 2019 Fiduciary Interpretation, account types, fullness/fairness of disclosure, risks of fees, expenses, best execution, undisclosed compensation arrangements
- Focus on TAMP platforms
- Perennial fee calculation errors
- Digital Assets



# Observations regarding Principal and Cross Trades

- July 21, 2021 Observations regarding Fixed Income Principal and Cross Trades
- Focus on Compliance Programs (Policies and Procedures)
- Focus on Conflicts of Interest
- Focus on Disclosure
- Points in this set of Observations equally apply to Principal and Cross Trades of any Asset Type



# Upcoming Webinars in this series

- September 14, 2021: Highlights of the Advisers Act New Marketing Rule
- September 21, 2021: Enforcement Trends Affecting Investment Advisers and Other Fiduciaries
- September 30, 2021: Attorney Conduct Rules & Escalation of Issues



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