

2023 Investment Adviser Compliance Conference Considerations for Institutional Clients

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The below outline highlights key areas in the life cycle of an institutional adviser's client relationship. We first cover the basics of an institutional adviser – including how it functions and the types of clients that it attracts. We next move to a discussion around how an institutional adviser markets itself to prospects, issues it encounters when negotiating client agreements, and certain onboarding issues. Next, the outline touches on an institutional adviser's management of client assets, issues with reporting (as to clients and regulatory reporting obligations), before finally moving to a discussion of issues pertaining to a client's termination of its adviser.

1. Inside an Institutional Adviser – a typical institutional adviser will commonly include the following functional areas (*italics* indicate areas that may be outsourced):

- a. Investment Management
- b. Research
- c. *Trading*
- d. Marketing and Client Service
- e. *Operations*
- f. *Legal*
- g. *Compliance*
- h. *Accounting and Valuation*
- i. *Transfer Agent*
- j. *Administrator*

2. Typical Clients of an Institutional Adviser

- a. Pension Plans
 - i. Private company
 - ii. State and local government pension plans

- b. Sovereign wealth funds and other non-US investors
- c. Sub-advised funds
- d. Retirement programs
- e. Hedge funds
- f. High net worth and ultra-high net worth individuals

3. Marketing to Prospects/RFP responses – Issues that commonly arise can relate to:

- a. Revised Investment Advisers Marketing Rule¹
 - i. Performance Presentation Issues
 - ii. Solicitation Issues
- b. Marketing to Government Entities
 - i. Investment Adviser Pay-to-Play Rule²
 - ii. State and Local Rules
- c. Marketing of Commingled Vehicles
 - i. Are interests in vehicles generally required to be marketed by a broker-dealer?
 - 1. Yes:
 - a. Can adviser and personnel avail themselves of an exemption from broker-dealer registration?³
 - b. If not, what registrations/licenses are needed?
 - 2. No:
 - a. Who are parties eligible to purchase the vehicle?
- d. Marketing of Private Funds:

¹ 17 C.F.R. § 275.206(4)-1.

² 17 C.F.R. § 275.206(4)-5.

³ *E.g.*, 17 C.F.R. § 240.3a4-1

- i. Rule 506(b) under Regulation D⁴:
 - 1. no “general solicitation” or “general advertising”;
 - 2. offerees may “self-certify” accredited investor status.
- ii. Rule 506(c) under Regulation D⁵:
 - 1. general solicitations OK; but
 - 2. issuer must conduct reasonable verification steps, even if all of its investors are in fact accredited investors.
- e. Delivery of Form ADV
- f. RFP Responses:
 - i. Preparation and review of “stock” responses to commonly-asked questions.
 - ii. Review of responses to unique questions.
 - iii. Assuring consistency of RFP responses with disclosures elsewhere in firm, policies and procedures, and practices.
 - iv. Assuring that proper subject matter experts have drafted/reviewed/approved RFP responses.

4. Negotiating the Agreement:

- a. What type of agreement?
 - i. Institutional separate account: Investment Management Agreement
 - ii. Private fund: Subscription Agreement
 - iii. Collective Investment Trust: Participation Agreement
 - iv. Institutional ‘40 Act Fund: Subscription Agreement
 - v. Wrap Account: Investment Management Agreement
- b. Investment Management Agreements – considerations:
 - i. Client Investment Guidelines:

⁴ 17 C.F.R. § 230.506(b).

⁵ 17 C.F.R. § 230.506(c).

1. Have portfolio managers reviewed?
 2. Would restrictions cause account to be included in restricted GIPS composite (if manager claims compliance with GIPS)?
- ii. Brokerage:
1. Are soft dollars involved? If so and the client or portfolio manager is in Europe, consider MiFID II compliance.
 2. Directed brokerage?
 - a. Soft (directed brokerage target is subject to best execution) or Hard (directed brokerage target is not subject to best execution) direction?
 - b. If directed brokerage target is material and not subject to best execution, will client waive best execution?
 3. Minimum credit rating requirements for broker-dealers executing client transactions?
 4. Affiliation issues?
 5. Trade aggregation?
 6. Agency cross authorization?
- iii. Proxies: Whose guidelines? If not adviser, how to ensure voting is implemented.
- iv. Corporate actions? Whose responsibility to process.
- v. Standard of care: Does ERISA, prudent investor, or other standard of care apply?
- vi. Liability:
1. Employee Retirement Income Security Act of 1974 (“ERISA”) clients
 2. Standard of liability with withdrawal of Heitman Capital no-action letter⁶

⁶ *Commission Interpretation Regarding Standard of Conduct for Investment Advisers*, Investment Advisers Act Rel. No. 5248 (June 5, 2019), 84 Fed. Reg. 33669, 33672 n. 31 (July 12, 2019).

- a. rescinded/continued viability of hedge clauses
 - b. impact of anti-waiver clauses on viability of hedge clauses.
- 3. Agree to strict liability?
- 4. Liability for brokers or third parties?
- 5. Cybersecurity?
- vii. Confidentiality/Non-use:
 - 1. Investment Adviser:
 - a. Portfolio holdings information
 - b. Material non-public information (“MNPI”) or proprietary information learned from investment adviser.
 - 2. Client:
 - a. Identity:
 - i. For marketing
 - ii. For opening accounts with brokers/Futures Commission Merchants (“FCM”)/banks
 - b. Use of Account (Anonymized) as Representative Account
 - c. Power of Attorney
 - i. power will not extend to the power to delivery monies to yourself
- viii. Client Representations:
 - 1. [if strategy requires derivatives] that it will execute all documentation required to enable manager to implement derivatives.
 - 2. Qualified Institutional Buyer (“QIB”)? (continuing representation)
 - 3. Regulation S under the U.S. Securities Act of 1933?⁷
 - 4. Accredited Investor? (continuing representation)

⁷ 17 C.F.R. §§ 230.901 – 230.904.

5. FINRA Rule 5130 (Restrictions on the Purchase and Sale of Initial Equity Public Offerings)
 6. FINRA Rule 5131 (New Issue Allocations and Distributions) representations? (continuing representation)
- ix. Unmanaged Assets – charging fees on.
 - x. Charging Fees on Investments in Underlying Commingled Vehicles that Charge Own Advisory Fees:
 1. Affiliated
 2. Third Party
 - xi. Most Favored Nations (“MFN”)
 1. Fees
 2. Terms and Conditions
- c. Private Fund Subscription Agreements and Supplemental Questionnaires – considerations:
 - i. Is Fund Relying Upon Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940 (the “1940 Act”).⁸
 1. If Section 3(c)(7), questions must elicit whether investor qualifies as qualified purchaser or knowledgeable employee.
 2. If Section 3(c)(1), questions must elicit:
 - a. whether fund must look through entity to underlying investors for purposes of determining compliance with Section 3(c)(1)’s limits on the number of beneficial owners; and
 - b. if the fund charges a performance fee, whether the investor qualifies as qualified client or knowledgeable employee.
 - ii. Accredited Investor Status
 - iii. Restricted Person/Covered Person Status under FINRA Rules 5130/5131
 - iv. ERISA/Benefit Plan Investor Status

⁸ 15 U.S. Code § 80a-3(c)(1) and (c)(7).

- v. Privacy Notice
 - vi. Anti-Money Laundering (AML)
 - vii. Know Your Customer (KYC)
 - viii. Personal Equity Plan (PEP)
 - ix. Tax/Foreign Account Tax Compliance Act (FATCA) information.
 - x. MFNs/Preferential Terms:
 - 1. Fees
 - 2. Terms and Conditions
- d. Collective Investment Trust (CIT) Participation Agreement - Considerations
- i. Representation that investor is eligible to invest in CIT
 - 1. Will the trustee supplementally require a determination letter or some other type of evidence of plan qualification?
 - ii. Fees (if fund/share class has externalized fees)
 - 1. MFNs
 - iii. Acknowledgement that Declaration of Trust/Fund Description trumps Participation Agreement.
- e. Institutional 1940 Act Investments
- i. If fund interests not registered under Securities Act of 1933, accredited investor representations required from subscriber.
 - ii. If performance fee charged (other than fulcrum fee), qualified client representations required from subscriber.
 - iii. Otherwise, governed by eligibility criteria set by 1940 Act fund.
- f. Wrap:
- i. Scope of services to be provided
 - ii. Brokerage?

1. Fully Discretionary?
 2. Directed?
 3. Need to reimburse client if trade executed away from sponsor?
- iii. Reliance on Platform:
1. For custody
 2. For trading

5. Onboarding Clients:

a. Institutional Separate Accounts

- i. Obtaining AML/KYC/PEP Information
- ii. Obtaining tax information
- iii. Obtaining information to verify status as:
 1. QIB?
 2. Regulation S non-US investor?
 3. Accredited Investor?
 4. FINRA Rule 5130/5131 representations

What do you do when your client service representative comes to you and says that client comes from [Country X] and in the culture of Country X, it is disrespectful to ask the client these questions, as you are assumed to know the answers to these questions, and if you ask them, the client will terminate the agreement and our biggest new account of the year is out the door?

b. Institutional Separate Accounts and CITs – transition management

- i. cash:
 1. invest yourself
 - a. CIT: charge client for performance drag/transaction fees?
 - b. CIT: dedicated account?

- c. Institutional account: performance holiday until account fully invested?
 - 2. Hire transition manager
 - a. Assuring confidentiality of recommendations
- ii. In-kind:
 - 1. transition yourself:
 - a. for institutional separate account, can you get performance holiday?
 - b. What is your fee and what are your obligations during transition management?
 - 2. Have client hire transition manager: same confidentiality of recommendations issues exist.

6. Management of Client Assets:

- a. Trading Issues:
 - i. Aggregation
 - 1. Aggregation of Investment Opportunities
 - 2. Aggregation of Proceeds of Executions
 - 3. Continued Vitality of Investment Company Institute (ICI) No-Action Letter given SEC staff will not extend Securities Industry and Financial Markets Association (SIFMA) MiFID II No-Action Letter.⁹
 - 4. Pulling Orders out of Aggregated Order Due to Affiliation, Brokerage Direction or other restrictions.
 - ii. Soft Dollars and MiFID II
 - 1. How are you preparing for non-extension of SIFMA MiFID II No-Action Letter.

⁹ See Securities Industry and Financial Markets Association (SEC No-action Letter) (pub. avail. Oct. 26, 2017); Securities Industry and Financial Markets Association (SEC No-action Letter) (pub. avail. Nov. 4, 2019); William Birdthistle, Director, Division of Investment Management: Remarks at PLI: Investment Management 2022 (July 26, 2022).

2. What impact will it have on:
 - a. U.S. clients; and
 - b. European Union and United Kingdom clients
 3. What impact has relaxation of inducement prohibition on small cap transactions had?
- b. Reporting Issues:
- i. Client/Investor Reporting:
 1. Keeping track of items of information to be reported to each client.
 2. Keeping track of schedule of when information must be reported.
 3. Are certain clients/investors obtaining certain items of information:
 - a. Earlier than other clients/investors?
 - b. That other clients/investors do not receive?
 4. Reporting of compliance breaches.
 5. Reporting/remediation of trade errors.
 6. Reporting of Proxy Votes.
 - ii. Regulatory Reporting:
 1. What reports must be filed with what regulators?
 2. Which reports are for clients/investors to file; which reports are for adviser to file?
 3. Form 13F – if you are a sub-adviser, do you report sole discretion or shared discretion? Why?
- c. Monitoring Issues:
- i. What is monitored in real time?
 - ii. What is monitored on a daily basis?

- iii. What is monitored on a weekly basis or less frequently?
- iv. How are warnings communicated to portfolio managers?

7. Termination:

- a. How much advance notice is required?
- b. When does your fee terminate?
- c. What obligations of the adviser and of the client/investor survive termination?
- d. Are any post-termination obligations triggered? For example:
 - i. to cooperate in good faith with transitioning to the new manager?
 - ii. to turn over books and records?
 - iii. to assist in responding to any regulatory inquiry?