Investment Services Regulatory Update

December 2019

VedderPrice

New Rules, Proposed Rules, Guidance and Alerts

PROPOSED RULES

SEC Proposes Rule Changes for Proxy Advisory Firms

On November 5, 2019, the SEC issued a release proposing amendments to the federal proxy rules that are intended to enhance the accuracy and transparency of information provided by proxy advisory firms to investors and investment advisers that vote proxies on behalf of their clients.

Rule 206(4)-6 under the Investment Advisers Act of 1940 requires registered investment advisers to adopt and implement policies and procedures reasonably designed to ensure that they vote proxies in the best interest of clients. Soon after Rule 206(4)-6 was adopted, the SEC staff issued two no-action letters—Egan-Jones Proxy Services (May 27, 2004) and Institutional Shareholder Services, Inc. (Sept. 15, 2004)—indicating that advisers could demonstrate proxies were voted in their clients' best interest by voting proxies based on a recommendation of an independent third party, subject to certain conditions. In response, many advisers engaged an independent proxy advisory firm to provide voting advice and recommendations. These no action letters were rescinded by the SEC staff prior to a proxy roundtable held in November 2018, but the practical effects of this rescission were minimal because most advisers were able to continue to rely on SEC Staff Legal Bulletin No. 20, issued in 2014, which contained similar guidance. In August 2019, the SEC staff issued interpretive guidance regarding advisers' proxy voting responsibility, including the view that a voting recommendation given by a proxy advisory firm generally constitutes a "solicitation" that is subject to the federal proxy rules.

Following the SEC staff's August 2019 proxy voting guidance, the SEC proposed amendments to the proxy rules related to the use of proxy advisory firms in November 2019. These proposed amendments include the following:

- **Definition of Solicitation.** The proposed amendments would codify the SEC staff's interpretation that voting advice given by a proxy advisory firm constitutes a "solicitation" within the meaning of Rule 14a-1 under the Securities Exchange Act of 1934. The practical consequence of this interpretation would be that proxy advisory firms generally would become subject to the information and filing requirements in the federal proxy solicitation rules unless an exemption is available.

For more information, see Vedder Price P.C.'s summary of the SEC staff's August 2019 proxy voting guidance, *SEC Issues Proxy Voting Guidance*, which is available here.

- **New Conditions for Reliance upon Proxy Solicitation Exemptions.** The proposed amendments would add two new conditions to the exemptions in Rule 14a-2 that are typically relied upon by proxy advisory firms.
  - **Conflict of Interest Disclosure.** To rely upon the exemptions, a proxy advisory firm would be required to prominently disclose any material conflicts of interest.
  - **Review by Registrant.** To rely upon the exemptions, a proxy advisory firm would be required to give the registrant whose shareholders are being asked to vote on a matter upon which the advisory firm has provided proxy voting advice an opportunity to review and provide feedback on that advice before the advice is delivered to clients. The purpose of this condition is to identify factual errors, incompleteness or methodological weaknesses in the advisory firm's analysis.
- **Antifraud Provisions.** The proposed amendments make it clear that proxy voting advice is subject to the antifraud provisions of Rule 14a-9 under the Exchange Act, which provides that a proxy solicitation may not contain a material misstatement or omission. To avoid a potential violation, a proxy advisory firm may need to disclose certain information, such as the methodology used to reach a recommendation, any third-party information used in its analysis and any material conflicts of interest. The proxy advisory firm would also be required to disclose any material differences between its use of standards that materially differ from standards or requirements established or approved by the SEC. For example, if a proxy advisory firm were to recommend against the election of a director on the basis of independence using proprietary standards developed by the proxy advisory firm, as opposed to the SEC's standards, it may be necessary for the advisory firm to state that its recommendation is based on

independence standards that differ from those of the SEC.

The SEC's proposing release is available here.

SEC Proposes Amendments to Shareholder Proposal Rule

On November 5, 2019, the SEC issued a release proposing amendments to Rule 14a-8 under the Securities Exchange Act of 1934, which is the rule that governs the process through which shareholders may submit proposals to be included in a company's proxy statement. If adopted, the proposal would amend Rule 14a-8 as follows:

- **Share Ownership Requirement.** At present, Rule 14a-8 requires that a shareholder must have owned at least $2,000 in market value, or 1 percent, of a company's securities in order to submit a shareholder proposal for inclusion in the company's proxy statement. The proposal sets forth a three-tiered ownership requirement structure, under which shareholders who own a smaller dollar amount of securities would be required to own those securities for a longer period of time before submitting a shareholder proposal.
- **Written Statements.** The proposal would add requirements that a shareholder provide the company with written statements to the effect that the shareholder intends to continue to hold the requisite amount of securities through the date of the shareholder meeting and that the shareholder will be available to discuss the proposal with the company between 10 and 30 days of submission.
- **One Proposal.** Rule 14a-8 currently provides that each shareholder may submit no more than one proposal to a company for a particular shareholder meeting. The current rule would be narrowed so that a single person may submit only one proposal for a particular meeting, whether submitted directly as a shareholder or indirectly as a shareholder representative.
- **Resubmission.** The proposal would also raise the levels of shareholder support that a previous proposal must have received in order to be eligible for resubmission at the same company's future shareholder meeting and would add a new provision that would allow companies to exclude proposals under certain circumstances in which shareholder support for the matter declines year over year.

The SEC requested comments as to whether special provisions should be considered for the amendment to Rule 14a-8 that would require shareholders to reaffirm proposals for open-end funds (which typically do not hold annual shareholder meetings) after some passage of time or, absent reaffirmation, allow the proposals to expire.

Comments on the SEC's proposal are due 60 days after publication of the proposal in the Federal Register.

The SEC's release is available here.

SEC Proposes Amendments to Modernize Adviser Advertising and Solicitation Rules

On November 4, 2019, the SEC proposed significant amendments to the rules under the Investment Advisers Act of 1940 governing investment adviser advertisements and compensating solicitors.

If adopted, the amendments to Rule 206(4)-1 under the Advisers Act—the Advertising Rule—which has not been changed substantively since its adoption in 1961, would modernize the regulation of adviser advertising to account for technological developments, changing investor profiles and consumer habits by, for instance, permitting the use of testimonials, endorsements and third-party ratings, subject to certain conditions, and generally replacing broadly drawn limitations with a principles-based approach. Notably, the proposed amendments to the Advertising Rule would in some cases impose different requirements depending on whether an advertisement was intended for a retail investor or a non-retail investor. In addition, the SEC proposed amendments to Rule 206(4)-3—the Solicitation Rule—that are intended to respond to changed industry practices since that rule's adoption in 1979.

Members of Vedder Price's Investment Services group have separately published a summary of the proposed amendments to the Advertising Rule and the Solicitation Rule. That summary is available here.

SEC GUIDANCE

SEC Staff Updates Prior Accounting Guidance and Publishes Accounting Matters Bibliography

On November 27, 2019, the Chief Accountant of the SEC's Division of Investment Management issued a "Dear CFO" letter—the first in nearly 20 years—to update certain accounting guidance appearing in prior Dear CFO letters that has become obsolete or been superseded or mooted by changes in the federal securities laws or U.S. generally accepted accounting principles since the last Dear CFO letter was issued in 2001. In the letter, the Chief Accountant also stated that the practice of issuing Dear CFO letters was being revived, to provide a method of conveying staff views to all registrants consistently and transparently.

Also on November 27, 2019, the Office of the Chief Accountant of the SEC's Division of Investment Management published a new Accounting Matters Bibliography, which is intended to serve as an evergreen source for the staff's current positions on accounting matters relevant to investment company registrants as expressed in Dear CFO letters. The bibliography will be updated to reflect new and changed staff positions over time.

The Dear CFO letter noted one new staff position, the details of which are set forth in the Accounting Matters Bibliography, relating to Section 19(a) of the Investment Company Act of 1940. Section 19(a) prohibits a fund from making a distribution from any source other than the fund's net income "determined in accordance with good accounting practice" unless the payment is accompanied by a written statement that adequately discloses the sources of the payment. The staff's view is that good accounting practice in this case means financial information prepared in accordance with U.S. GAAP. But the staff would not object if the tax basis is used to prepare that financial information instead, provided the basis for calculating the sources of the distribution is used consistently. In addition, the staff expressed the view that funds should not use tax forms provided to investors, including IRS Form 1099-DIV, to comply with Section 19(a) because these forms are not delivered contemporaneously with each distribution.

The November 27, 2019 Dear CFO letter is available here.

The Accounting Matters Bibliography is available here.

SEC Staff Issues Form CRS FAQs

On November 26, 2019, the staff of the SEC's Division of Investment Management and Division of Trading and Markets issued guidance in the form of frequently asked questions (FAQs) relating to the requirements of Form CRS, which was adopted on June 5, 2019 in conjunction with Regulation Best Interest. Beginning in 2020, registered investment advisers and broker-dealers will be required to file with the SEC, and deliver to retail investor clients, a relationship summary on Form CRS disclosing information about their firm. The published FAQs addressed questions relating to the format of the form and form delivery requirements. The following is a summary of the staff's guidance:

- **Firms Offering Multiple Services Must File a Single Form CRS.** Investment advisers and broker-dealers that offer more than one type of service to retail investors must file and deliver a single Form CRS. For example, an investment adviser that offers a wrap fee program, 401(k) plan advice and discretionary asset management for individual clients would file a single Form CRS describing all of those services. Similarly, a broker-dealer that provides self-directed, full-service and employer-sponsored retirement plan options would prepare a single Form CRS. Any firm dually registered as both an investment adviser and broker-dealer may summarize all of its advisory and brokerage services on a single Form CRS or prepare two separate relationship summaries for its investment advisory and brokerage businesses.
- **How to Make Machine-Readable Headings.** The instructions to Form CRS require investment advisers and broker-dealers to file the form in a text-searchable format with machine-readable headings. The SEC staff provided a three-step approach on how to create a PDF document with machine-readable headings to satisfy this requirement.
- **Form CRS May Be Delivered to Clients Together with June 2020 Account Statements.** For existing retail investor clients, the SEC staff confirmed that investment advisers and broker-dealers may deliver their Forms CRS either separately

or as part of their standard investor correspondence within 30 days of the June 30, 2020 compliance date. If the Form CRS is delivered in paper along with other documents, it must be the first among those documents. If the Form CRS is delivered electronically, it must be presented prominently and easily accessible.

- **Forms CRS Need Not Be Delivered to Retail Investors in Pooled Investment Vehicles.** Pooled investment vehicles such as hedge funds, private equity funds and venture capital funds are not included under the definition of "retail investors." Investment advisers are not required to deliver Forms CRS to pooled investment vehicle clients or to individual investors in those vehicles who may themselves be retail investors.

The SEC expects to update the FAQs from time to time to address additional questions.

The FAQs are available here.

For more information about Form CRS and Regulation Best Interest, please see the Vedder Price white paper, *The New Standards for Investor Protection: An Analysis of Regulation Best Interest, Form CRS and Two Interpretations of the US Investment Advisers Act*, available here.

SEC Extends Temporary Relief for MiFID II-Compliant Research Payments

On October 26, 2017, the SEC staff issued a no-action letter providing relief to broker-dealers that provide research that constitutes "investment advice" under the Investment Advisers Act of 1940 to investment managers subject to the prohibitions on soft-dollar use imposed by the European Union's amended Markets in Financial Instruments Directive (MiFID II), which took effect in January 2018. Under the relief, broker-dealers are able to receive payments for this research from investment managers paying their own money (i.e., "hard dollars"), from separate research payment accounts funded with client money or from a combination of the two. Absent this relief, a broker-dealer receiving these sorts of compensation for providing research that constitutes investment advice would be required to register as an investment adviser under the Advisers Act. The 2017 no-action relief was temporary and set to expire on July 3, 2020.

On November 4, 2019, the SEC staff extended for three additional years the temporary relief granted in the 2017 no-action letter. Accordingly, the relief will now expire on July 3, 2023 unless further action is taken. The SEC staff stated that the extension of the relief would allow the staff to further monitor and assess the effects of MiFID II on the market for research, including the effects of MiFID II on small- and mid-sized entities, and to consider whether additional guidance or recommendations are necessary. The SEC also noted that the additional time would enable EU regulators to evaluate the effects of MiFID II and consider modifications to their rules.

The SEC staff's October 26, 2017 no-action letter is available here.

The SEC staff's November 4, 2019 letter extending the 2017 relief is available here.

Public Statements, Press Releases and Testimony

SPEECHES

Remarks of Dalia Blass at the ALI CLE 2019 Conference on Life Insurance Company Products

On November 7, 2019, Dalia Blass, Director of the SEC's Division of Investment Management, delivered the keynote address at the annual ALI CLE Conference on Life Insurance Company Products. Her remarks primarily focused on the staff's rulemaking activity over the prior year. Ms. Blass discussed comments received on the SEC's proposal to permit issuers of variable contracts to use a summary prospectus. She stated that significant comments had been received on the treatment of discontinued contracts, the use of structured data using inline XBRL tagging and the proposed use of standardized terminology in disclosure documents. She stated that a final rule was expected by April 2020. Ms. Blass also discussed the SEC's recent proposal to modernize the investment adviser advertising and solicitation rules, noting that the proposed rule "recognizes the evolution of the market place and how investors look for and receive information" since the adoption of the original rule. Ms. Blass pointed to the recent adoption of the ETF rule and the expedited review process for certain exemptive applications as initiatives that the staff hoped would create more

investment options for investors by reducing costs for sponsors. Ms. Blass concluded her remarks by noting that the staff's recent regulatory initiatives have been part of the staff's ongoing focus on protecting investors, improving the investor experience and modernizing the regulatory framework.

A transcript of Ms. Blass's remarks is available here.

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With significant experience in all matters related to design, organization and distribution of investment products, Vedder Price can assist with all aspects of investment company and investment adviser securities regulations, compliance issues, derivatives and financial product transactions, and ERISA and tax inquiries. Our highly experienced team has extensive knowledge in structural, operational and regulatory areas, coupled with a dedication to quality, responsive and efficient service.