Investment Services Regulatory Update

July 2022

Monthly Version

VedderPrice

New Rules, Proposed Rules, Guidance and Other SEC Developments

SEC DEVELOPMENTS

SEC Issues Statement and Request for Comment on Certain Information Providers Acting as Investment Advisers

On June 15, 2022, the SEC published a request for comment on certain information providers, including index providers, model portfolio providers and pricing services, whose activities the SEC believes may cause them to meet the definition of "investment adviser" under the Advisers Act. The SEC noted the proliferation of such information providers in recent years and the potential for conflicts of interest that such information providers' activities may present. Although previously such information providers (especially index providers) were widely considered to be excluded from the statutory definition of an investment adviser pursuant to the "publisher's exclusion" and judicial interpretations thereof, the SEC's request for comment indicates an interest in reexamining the continued applicability of such exclusion.

A requirement that information providers register as investment advisers under the Advisers Act would impose significant costs, prohibitions and other requirements, including, among others, Form ADV filings, recordkeeping obligations and periodic SEC examinations. In addition, if an information provider is deemed to be an investment adviser under the Advisers Act, it could also be considered an investment adviser to a fund under the 1940 Act. In such event, the relationship with an information provider would be subject to numerous requirements under the 1940 Act, including annual review and approval of the contract with the information provider by the fund's independent board members.

Below are the types of information providers that the SEC considered and a few of the key SEC requests for comments.

Index Providers
The SEC noted the development of narrowly-focused or specialized indices, and the significant discretion that index providers may have in changing the index constituents or modifying their weightings. The SEC also noted that the decision to include or exclude a particular security may have implications for the larger market for such security, including causing funds that track the index to buy or sell the security.

Model Portfolio Providers
The SEC pointed to the growth of model portfolio providers, who may design and offer allocation models in exchange for a commission or other fees. The SEC noted its concerns with respect to the transparency of fees and services provided, and the discretion such providers may exercise in designing model portfolios. Also highlighted by the SEC were the customization and model adjustments that may be made based on input from the adviser.

Pricing Services
The SEC cited its concern that pricing services may exercise significant discretion in determining valuation methodologies, developing valuation model templates, determining the sources or relevance of inputs, determining whether valuations generated are appropriate and addressing valuation challenges. The SEC referenced its own concerns about pricing service compliance issues from a 2008 compliance alert.

Summarized below are certain of the SEC's requests for comment with respect to investment adviser status under the Advisers Act:

- Are the SEC's descriptions of the information providers accurate, in particular with respect to the types of risks and conflicts of interest that each type of provider represents, as well as the information providers' use of discretion in performing their services?
- Are there are other types of information providers whose activities may raise Advisers Act concerns?
- How do information providers analyze whether they meet the definition of an investment adviser, and what is the basis for their determination of whether they qualify for exemptions from such definition, including the publisher's exclusion?

- What form of compensation do information providers receive?
- How do information providers exercise discretion in providing information? Do they customize or adjust their processes based on input from clients? How do information providers disclose adjustments or changes to their services?
- What are additional economic benefits and costs associated with registering as an investment adviser, and are there any provisions of the Advisers Act that would be impossible to comply with or that would be operationally complex and burdensome? Should information providers be exempted from certain requirements of the Advisers Act even if they meet the definition of "investment adviser?"
- For index providers, what issues are raised by the provision of specialized versus broad-based indices? Do customized or bespoke indices raise particular investment adviser status issues?
- Would requiring information providers to register as investment advisers and become subject to current Advisers Act requirements cause them to alter their business models, consolidate or exit the market?

In addition, the SEC requested comment with respect to potential 1940 Act ramifications that could arise if an information provider is classified as an investment adviser. These requests include:

- How do information service providers analyze whether they meet the 1940 Act definition of an investment adviser to a fund? What are the costs and benefits associated with meeting that standard, and would application of the standard serve as a material barrier to new entrants?
- To what extent do information providers enter into contracts with funds directly? If a fund's adviser delegates services to an information provider, how are the duties allocated between the adviser and delegatee?
- How much time would be required for funds and information providers to come into compliance with the 1940 Act requirements for investment advisers to a fund, if those requirements are applied? Should the SEC take additional measures to assist with compliance?
- Are existing fund relationships with information providers currently subject to fund compliance programs under Rule 38a-1 under the 1940 Act, and should Rule 38a-1 be amended to incorporate oversight of information providers?

The statement and request for comment is available here. The public comment period will remain open until August 16, 2022.

Regulatory Agenda Highlights Potential and Pending SEC Rulemaking Topics

On June 22, 2022, the Office of Information and Regulatory Affairs—part of the Office of Management and Budget, within the Executive Office—released the Spring 2022 Unified Agenda of Regulatory and Deregulatory Actions, reporting on potential rulemaking topics that administrative agencies, including the SEC, will consider in the short and long term, including several areas of interest to funds and investment advisers, with topics categorized as in the "proposed rule stage" or "final rule stage."

Notable New Items: Fund Fee Disclosure and Reform; Digital Engagement Practices

Notably, new to the SEC's regulatory agenda and categorized in the proposed rule stage is an item titled "Fund Fee Disclosure and Reform" concerning the consideration of potential changes to the regulatory requirements relating to registered investment companies' fees and fee disclosure. Also identified as new to the agenda are digital engagement practices for investment advisers and broker-dealers, indicating that the Division of Investment Management is considering recommending that the SEC propose rules related to "the use of predictive data analytics, differential marketing and behavioral prompts."

Recent Regulatory Developments

Other items listed in the agenda reflect recent regulatory developments that have garnered considerable attention in the asset management industry, such as recently proposed rules relating to funds and investment advisers to address matters relating to environmental, social and governance factors, proposed amendments to the fund names rule and the SEC's request for comment on the role of certain third-party information service providers and their potential treatment as investment advisers.

Additional Items of Note

Additional items of note included in the regulatory agenda are potential new or amended rules concerning the following:

- Proposed Rule Stage:
  - custody rule for investment advisers;
  - listing and trading of exchange-traded products; and
  - open-end fund liquidity and dilution management.
- Final Rule Stage:
  - tailored shareholder reports, treatment of annual prospectus updates for existing investors, and improved fee and risk disclosure for mutual funds and ETFs; fee information in investment company advertisements;
  - proxy votes by funds and reporting on executive compensation votes by institutional investment managers;
  - money market fund reforms relating to the proposed removal of the liquidity fee and redemption gate provisions in the existing rule and the implementation of swing pricing policies and procedures for certain money market funds;
  - private fund adviser matters relating to conflicts of interest and transparency and documentation of adviser compliance reviews;
  - shortening of the securities transaction settlement cycle;
  - modernization of beneficial ownership reporting;
  - short sale disclosure reform;
  - Form PF and reporting requirements for large private equity advisers and large liquidity fund advisers; and
  - further definition of dealers.

The SEC's rulemaking list is available here.

Senate Confirms Two New SEC Commissioners

On June 16, 2022, the U.S. Senate confirmed Jaime Lizárraga and Mark Uyeda to serve as SEC Commissioners. Mr. Lizárraga fills the position previously held by departing Commissioner and former Acting SEC Chair Allison Herren Lee. Mr. Uyeda fills the position previously held by former Commissioner Elad Roisman. SEC Chair Gary Gensler and Commissioners Hester Peirce and Caroline Crenshaw are continuing members of the five-person SEC.

A statement from the SEC on the confirmation of Messrs. Lizárraga and Uyeda is available here.

NEW RULES

SEC Adopts Amendments to Electronic Filing Requirements

On June 23, 2022, the SEC adopted various rule and form amendments that will require the electronic submission of certain documents that may currently be filed in paper format by registered investment advisers, institutional investment managers and other entities. Additionally, the amendments include certain technical amendments intended to modernize Form 13F and applications for orders submitted under the Investment Advisers Act of 1940 and the Investment Company Act of 1940. The SEC adopted the amendments with the goal of promoting more efficient storage, retrieval and analysis of filings and submissions.

The rule and form amendments will require the electronic submission through the EDGAR system of applications for orders under the Advisers Act and confidential treatment requests relative to Form 13F filings. The amendments will also require the electronic submission through the Investment Adviser Registration Depository System of Form ADV-NR filings. In addition, the amendments will add requirements for enhanced identifying information in Form 13F. In an effort to harmonize the requirements for the submission of applications for orders under the Advisers Act and the Investment Company Act, the amendments will eliminate requirements to notarize verifications and

statements of fact in, and to include proposed notices as exhibits to, Advisers Act applications. Finally, the amendments will remove references to microfilming from the rules specifying the requirements for applications submitted under the Advisers Act and the Investment Company Act.

The new rules and form amendments will be effective on August 29, 2022. The amendments to Form 13F will be effective on January 3, 2023, and there will be a six-month transition period to submit the required documents electronically.

The SEC's adopting release is available here, and a related press release is available here.

Reminder Regarding Approaching Compliance Dates for New SEC Rules

Funds and advisers should take note of the following approaching compliance dates:

- **August 1, 2022—Compliance with Closed-End Fund Inline XBRL Format Requirements**
    - As a result of the SEC's 2020 adoption of securities offering reform for closed-end funds, closed-end funds that are eligible to file a short-form registration statement will be required to comply with Inline eXtensible Business Reporting Language—or "iXBRL"—structured data format, involving the tagging of certain registration statement information.
- **August 19, 2022—Compliance with New Fund Derivatives Rule**
    - Rule 18f-4 under the 1940 Act reflects a wholesale replacement of the asset segregation-based regulatory regime for registered funds that engage in derivatives transactions. The implementation and compliance burdens are significant; among other things, a fund relying on the rule must adopt a multi-faceted derivatives risk management program and generally must calculate new types of risk measurements, such as daily "value-at-risk" (VaR), at least weekly VaR backtesting and at least weekly stress testing. A summary of Rule 18f-4 is available here. A recording of a webinar presented by Vedder Price attorneys Deborah B. Eades, W. Thomas Conner, Juan M. Arciniegas and Nathaniel Segal about the practical implications of the new derivatives rule is available here.
- **September 8, 2022—Compliance with New Fund Valuation Rule**
    - Rule 2a-5 under the 1940 Act provides a new framework for fund valuation practices and clarity on how fund boards may satisfy their statutory obligation to determine the fair value of fund investments. A summary of Rule 2a-5 is available here. Vedder Price attorneys John S. Marten, Jacob C. Tiedt and Kelly Pendergast Carr discussed the new fund valuation rule at a webinar presentation, a recording of which is available here.
- **November 4, 2022—Compliance with New Adviser Marketing Rule**
    - The new Marketing Rule under the Advisers Act represents a significant change to investment adviser practices with respect to advertising, cash solicitation and recordkeeping. Advisers must adopt new policies and procedures to comply with the Marketing Rule. A summary of the Rule is available here. Vedder Price hosted a webinar panel discussion about the new Marketing Rule, which featured Vedder Price attorneys Joseph M. Mannon and Robert M. Crea, as well as Julie Dixon, Founder and CEO of Titan Regulation, as panelists. A recording of the webinar is available here.

Litigation, Enforcement and Sanctions Developments

ENFORCEMENT PROCEEDINGS

SEC Settles Charges Against Mutual Fund Sub-Adviser for Overvaluing "Odd-Lot" Bonds

On June 3, 2022, the SEC announced the settlement of an administrative proceeding brought against a registered investment adviser for alleged violations relating to the valuation of certain bonds purchased in "odd lots" for a mutual fund it sub-advised. As a result, the sub-adviser is alleged to have caused the fund to overstate its daily net asset values and performance returns and to execute transactions in fund shares at those overstated values.

From May 2015 through July 2015, the sub-adviser purchased for the fund various "odd-lot" bonds, which tended to trade in smaller quantities and at a discount compared to bonds traded in larger quantities. However, the SEC alleged that the fund valued those bonds at the higher prices provided by a third-party pricing vendor intended for "round-lot" positions. The SEC alleged that the overvaluation of the odd-lot bonds caused the fund to overstate its daily net asset values and performance returns until at least March 2016. The SEC also alleged that the sub-adviser failed to adopt and implement policies and procedures to address its valuation responsibilities and that, as a result, the fund made misleading statements to investors in public filings and marketing materials by relying on the overstated performance information. In addition, the SEC alleged that from January 2017 to February 2019, the sub-adviser submitted bids to brokers on bonds already held by the fund at prices higher than those provided by the pricing vendor in an effort to raise the marks provided by the pricing vendor and thereby boost the fund's net asset value.

In settlement of the charges, without admitting or denying the findings set forth in the SEC's order, the sub-adviser agreed to a censure, to cease and desist from violating applicable provisions of and rules under the Investment Advisers Act of 1940 and the Investment Company Act of 1940 and to pay a civil monetary penalty of $3.5 million.

A copy of the SEC's order is available here.

SANCTIONS DEVELOPMENTS

OFAC Issues FAQs with Guidance on Russian Investment Prohibitions

On June 6, 2022, the U.S. Department of the Treasury's Office of Foreign Assets Control (OFAC) published guidance in the form of frequently asked questions clarifying certain sanctions against Russia set forth in executive orders issued in response to Russia's invasion of Ukraine. In particular, the FAQs clarify provisions of the executive orders that prohibit U.S. persons from making "new investments" in securities of Russian issuers.

Following the Russian invasion of Ukraine in February 2022, President Biden issued three executive orders relating to investments by U.S. persons in Russia:

- Executive Order 14066, issued March 8, 2022, which prohibits, among other things, new investments by U.S. persons in the Russian energy sector.
- Executive Order 14068, issued March 11, 2022, which prohibits, among other things, new investments by U.S. persons in Russian economic sectors as authorized by the U.S. Secretary of the Treasury in consultation with the U.S. Secretary of State.
- Executive Order 14071, issued April 6, 2022, which prohibits all new investments in Russia by U.S. persons, wherever they may be located.

Among the new FAQs issued by OFAC, FAQ 1049 clarifies that, for purposes of the foregoing executive orders, "new investments" include, among other things, purchases of real estate in the Russian Federation for other than personal use, lending funds to persons in Russia for commercial purposes, purchasing equity interests in an entity located in Russia and purchasing rights to natural resources in Russia, in each case pursuant to a commitment made after the effective dates of the applicable executive orders. FAQ 1054 clarifies that the new investment provisions of the foregoing executive

orders prohibit U.S. persons from purchasing any new or existing debt or equity securities issued by any entity located in Russia. FAQs 1053 and 1054 clarify that the executive orders do not prohibit U.S. persons from selling or otherwise divesting, or facilitating the sale or other divestment of, Russian debt or equity securities to a non-U.S. person, and that the executive orders do not require U.S. persons to divest Russian securities that they already hold. In addition, FAQ 1054 clarifies that the new investment prohibitions of the executive orders do not apply to the conversion of depositary receipts to local shares of non-sanctioned Russian issuers or to the purchase by U.S. persons of U.S. funds that invest in debt or equity securities issued by Russian issuers, provided Russian securities do not represent a "predominant share" by value of the fund's total assets. FAQ 1055 further clarifies that U.S. persons may lend funds to or purchase equity interests in entities located outside of Russia, so long as the funds are not specifically intended to fund new projects or operations in Russia and the entity's revenues are not "predominantly" derived from investments in Russia.

The FAQs specify that any transactions allowed under the executive orders may not in any event involve blocked persons or other prohibited transactions unless exempt or otherwise authorized by OFAC.

In addition to the FAQs related to the prohibitions on new investments in Russia, OFAC also issued a series of FAQs on June 9, 2022 relating to prohibitions on providing accounting, trust and corporate formation and management consulting services to persons located in Russia.

The full list of OFAC's FAQs relating to the Russian Harmful Foreign Activities Sanctions is available here.

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Vedder Price's Investment Services Group has received a 2021 Go-To Thought Leadership Award from the National Law Review in recognition of the Group's regular securities law thought leadership contributions and outstanding analysis of issues affecting the asset management industry.

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Investment Services Group

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.