# Investment Services Regulatory Update

## September 2021

### Monthly Version

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# New Rules, Proposed Rules, Guidance and Alerts

## PROPOSED RULES

## SEC Proposes Enhanced Proxy Voting Reporting Requirements for Funds and Managers

On September 29, 2021, the SEC announced proposed amendments to Form N-PX that, if adopted, would expand the information that registered funds must disclose about their proxy votes. The SEC's proposal would also impose Form N-PX reporting requirements on Form 13F filers—i.e., "institutional investment managers"—with respect to the managers' proxy voting records on say-on-pay proposals for securities over which those managers exercise voting power.

Highlights from the SEC's proposal include:

- **Standardized Language, Reporting Format and Website Availability of Information.** In order to enhance funds' current Form N-PX disclosures so investors can more easily understand and analyze proxy voting information, the SEC's proposal would require funds to use standardized descriptions of voting matters, more clearly tie the description of the voting matter to the issuer's form of proxy and categorize voting matters by type. In addition, the SEC's proposal would require information reported on Form N-PX to be submitted in a structured data language via an XML file or SEC-provided web-based form. The SEC also proposed to require funds to provide their proxy voting records on (or through) a fund's website.
- **Quantitative Disclosures, including for Securities on Loan.** The SEC's proposal would require funds to disclose the number of shares that were voted (or, if not known, that were instructed to be cast) and how those shares were voted, as well as the number of shares that were loaned and not recalled for the vote. Since funds currently are required to report information for each matter relating to a portfolio security considered at any shareholder meeting during the reporting period, and with respect to which the fund was "entitled to vote," the SEC proposed amending Form N-PX to provide that a fund will be entitled to vote on a matter if its portfolio securities are on loan as of the record date. This aspect of the proposal is intended to provide transparency into how a fund's securities lending activities affect its proxy voting practices.
- **Say-On-Pay Reporting on Form N-PX for Institutional Investment Managers.** In connection with the proposed amendments to Form N-PX, the SEC's proposed new rule 14Ad-1 would subject each person that is (i) an "institutional investment manager" as defined in the Securities Exchange Act of 1934 and (ii) required to file reports under Section 13(f) of the Exchange Act, to an annual Form N-PX reporting requirement with respect to votes on say-on-pay proposals—but only if the manager "exercised voting power" over the security. The proposed rule would establish a two-part test for determining whether a vote must be reported, requiring both power to vote a security (or to cause another party to vote such security) and the actual use of such power to influence the voting decision in the case of the specific vote. To the extent a manager did not exercise voting power over any securities that held say-on-pay votes during a given reporting period, the manager would file a Form N-PX report affirmatively stating that fact.

The SEC's proposal is available here. The public comment period will remain open for 60 days after publication of the proposing release in the Federal Register.

## OTHER DEVELOPMENTS

## SEC Requests Comment on Broker-Dealer and Investment Adviser Digital Engagement Practices

On August 27, 2021, the SEC requested information and public comment on the use of digital engagement practices (DEPs) by broker-dealers and investment advisers. DEPs include items such as behavioral prompts, differential marketing, gamification features and other elements or features designed to engage retail investors on digital platforms such as websites, portals and applications, and by providing asset management services through "robo-advising" or the use of algorithm-based platforms. The SEC encouraged industry market participants and retail investors to share their perspectives on the use of DEPs.

In the request for comment, the SEC stated its desire to understand and evaluate:

- the extent to which firms use DEPs;
- the types of DEPs most frequently used;
- the tools and methods used to develop and implement DEPs; and
- information pertaining to retail investor engagement with DEPs, including any data related to investor demographics, trading behaviors and investment performance.

In an accompanying press release, the SEC stated that the request for comment will facilitate the SEC's assessment of existing regulations and consideration of whether regulatory action may be needed.

Although the comment period has ended, the SEC's request demonstrates the SEC's interest in DEPs in light of the recent "meme stock investing" that occurred in stocks such as AMC Entertainment and GameStop earlier this year. The request was also foreshadowed by SEC Chair Gary Gensler's Congressional testimony in May 2021 on "meme stock investing" and its connection to easy-to-use trading apps and the use of artificial intelligence tools and other algorithms to curate investor experiences. Overall, it appears the SEC is trying to evaluate broker-dealers' and investment advisers' use of digital platforms designed to provide retail investors with greater market access and product choices, and the potential bias these platforms and DEPs may have to increase revenue, collect data and track and affect the amount of time a customer spends on any platform.

There has already been industry pushback through the public comment process. SIFMA, the industry trade group that represents market participants, commented that the existing regulatory framework of SEC and FINRA rules already addresses the use of DEPs, and therefore any new rules, guidance or interpretations would be unnecessary to regulate DEP usage.

The SEC's press release announcing the request for information and public comment is available here.

## IDC Requests Additional Relief with Respect to Fund Board In-Person Voting Requirements

On September 2, 2021, the Independent Directors Council submitted a letter to Sarah ten Siethoff, Acting Director of the SEC's Division of Investment Management, requesting at least six months' advance notice before the SEC withdraws its current relief from the Investment Company Act of 1940's in-person voting requirements applicable to fund boards. The IDC also requested that the SEC provide fund boards with greater flexibility regarding the 1940 Act's in-person voting requirements on a permanent basis.

In March 2020, in response to the outbreak of the COVID-19 pandemic, the SEC issued an exemptive order providing relief from certain 1940 Act provisions, including the in-person voting requirements applicable to fund boards with respect to the approval or renewal of advisory and underwriting agreements, the approval or renewal of distribution arrangements and the appointment of auditors,

subject to certain conditions. This relief was initially intended to be available only through June 2020, but the SEC issued subsequent extensions later in March 2020 and again in June 2020. In the June 2020 order, the SEC stated that the relief would terminate upon subsequent public notice, provided that at least two weeks' notice would be given before the expiration of the relief. A summary of the SEC's current relief is available here.

The IDC cited the continuing challenges fund boards face due to the COVID-19 pandemic, including transportation limitations, vaccination concerns and emerging COVID variants, as well as the generally favorable experience fund boards have had meeting virtually via videoconference during the pandemic. The IDC requested that the SEC not withdraw the current relief before the conclusion of the pandemic and that the SEC provide at least six months' advance notice before such withdrawal. The IDC stated that such advance notice, among other things, would provide greater certainty and allow fund boards and other parties to develop protocols and procedures to safely and effectively return to meeting in person.

In addition, also citing the generally favorable experience fund boards have had meeting virtually via videoconference, the IDC requested that the SEC provide permanent relief from the 1940 Act's in-person voting requirements so that fund boards would have the flexibility to meet virtually after the conclusion of the pandemic. The IDC suggested that such relief should be subject to certain conditions, including that boards adopt policies and procedures for the conduct of virtual meetings, including appropriate technology and security protocols; that directors who participate virtually be able to engage in contemporaneous communications with other participants; and that directors have the means to identify each person casting a vote virtually during a board meeting.

A copy of the IDC's letter is available here.

# Legislation

## Proposed Tax Legislation Could Impact Exchange-Traded Funds

On September 10, 2021, Senator Ron Wyden (D-Oregon), Chairman of the U.S. Senate Committee on Finance, proposed draft legislation aimed at eliminating certain perceived loopholes and ambiguities in the tax rules applicable to partnerships and other pass-through entities. Notably, the proposed legislation would repeal a tax code provision, Section 852(b)(6), that allows regulated investment companies (RICs), including mutual funds and ETFs, to avoid recognizing gain on appreciated securities when they satisfy shareholder redemptions in kind (i.e., providing portfolio securities rather than cash in exchange for fund shares).

Although the repeal of Section 852(b)(6) would impact redemptions in kind made by both mutual funds and ETFs, the tax preference afforded to in-kind distributions provided by Section 852(b)(6) is at present a key advantage of the ETF structure. Unlike mutual funds, which typically satisfy shareholder redemptions in cash, most ETFs rely on the ability to effect in-kind creations and redemptions of shares with authorized participants in the normal course of their operations and thereby avoid realizing taxable gains on appreciated securities. A repeal of Section 852(b)(6) would require ETFs to recognize gains on any appreciated securities distributed to authorized participants in routine in-kind redemptions. As a result, because RICs are required under the tax code to distribute substantially all of their income and gains each year to avoid U.S. federal income tax at the fund level, ETFs would need to distribute to shareholders gains recognized on in-kind redemptions, which generally would be taxable to shareholders unless their shares are held in a tax-advantaged account. In addition, ETFs may need to sell securities in order to raise cash to satisfy this annual distribution requirement, potentially incurring transaction costs and generating additional gains. This change would therefore eliminate a

key advantage ETFs currently enjoy vis-à-vis traditional mutual funds.

If the proposed legislation is enacted, the repeal of Section 852(b)(6) would apply to taxable years beginning after December 31, 2022.

A copy of the proposed legislation is available here, and a section-by-section summary is available here.

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## Investment Services Group

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