# Investment Services Regulatory Update

## November 2021

### Monthly Version

VedderPrice

# New Rules, Proposed Rules, Guidance and Alerts

## RISK ALERTS

### SEC Issues Risk Alert on Investment Advisers' Fee Calculations

On November 10, 2021, the Division of Examinations of the Securities and Exchange Commission (the Staff) issued a risk alert setting forth notable fee calculation-related deficiencies and related industry best practices observed by the Staff in a recently completed national examination initiative of investment advisers. Through the examination initiative, the Staff identified deficiencies with a majority of advisers examined. In the alert, the Staff noted that fee calculation-related deficiencies often result in financial harm to clients, and may involve violations of an adviser's fiduciary duty to clients and requirements under the Investment Advisers Act of 1940. Fee calculations and related disclosure have been a continued focus of the Staff in recent years. Advisers would be well-served to take note of the Staff's observations regarding industry best practices:

- **Adopt and implement written policies and procedures addressing advisory fee billing processes and validating fee calculations.** Advisers should have written policies and procedures addressing (a) advisory fee computing, billing and testing, and (b) monitoring of fee calculations. Advisory fee computing should include all critical components relevant to an adviser's business. Examples of such critical components identified by the Staff include: (i) valuation of illiquid or difficult-to-value assets, (ii) fee offsets, (iii) pre-paid fee reimbursements for terminated accounts, (iv) prorating fees for additions or subtractions to accounts, (v) family account aggregation (householding) and (vi) the application of breakpoints for fee calculations.
- **Centralize the fee billing process and validate that the fees charged to clients are consistent with compliance procedures, advisory contracts, and disclosures.** The Staff noted that advisers with a centralized process for advisory fee calculation and invoicing had more consistent fee billing practices.
- **Ensure resources and tools established for reviewing fee calculations are utilized.** The Staff observed that advisers utilizing checklists and similar resources to reconcile fee calculations with advisory agreements had more consistently accurate fee calculations.
- **Properly record all advisory expenses and fees assessed to and received from clients.**

The risk alert is available here.

### SEC Issues Risk Alert on Investment Advisers that Provide Electronic Investment Advice

On November 9, 2021, the Division of Examinations of the Securities and Exchange Commission (the Staff) issued a risk alert highlighting notable deficiencies and related industry best practices observed by the Staff in a recently completed national examination initiative of investment advisers that provide their clients with automated digital investment advisory services (otherwise referred to as robo-advisers). Through the examination initiative, the Staff identified deficiencies with a majority of advisers examined, most often relating to (i) compliance programs, including policies, procedures, and testing; (ii) portfolio management, including, but not limited to, an adviser's fiduciary obligation to provide advice that is in each client's best interest; and (iii) marketing and performance advertising, including misleading statements and missing or inadequate disclosure.

Robo-advisers would be well-served to take note of the Staff's observations regarding industry best practices:

- **Adopt, implement and follow written policies and procedures that are tailored to the adviser's practices.** Policies and procedures should be specific to an adviser's use of an online platform and/or other digital tools for the provision of investment advice. Policies and procedures should assess, among other things, whether the adviser's: (i) algorithms perform as intended, (ii) asset allocation and/or rebalancing services occur as disclosed, (iii) data aggregation services, if any, present any custody implications. Advisers utilizing white-label platforms should have policies and procedures addressing the platform providers' attention to such matters. Compliance programs must be tested at least annually.
- **Gather sufficient information from clients to form a reasonable belief that clients are receiving investment advice that is in their best interest, based on each client's financial situation and investment objectives.** Initial questionnaires used to formulate investment advice for clients should elicit sufficient information in order to reasonably determine initial and ongoing suitability of each client's investment strategy. Advisers should follow up with their clients periodically to inquire about any changes to their financial situation or investment objectives, or require them to retake the initial questionnaire.
- **Test algorithms periodically to ensure they are operating as expected.**
- **Create information barriers to safeguard algorithms. Advisers should limit code access to authorized personnel.** Compliance should be notified in advance of a substantive algorithm change or override. If using a white-label platform, the platform provider should notify the adviser of any such changes.

The risk alert is available here.

## Division of Examinations Risk Alert Identifies Compliance Issues at Registered Investment Companies

On October 26, 2021, the SEC's Division of Examinations issued a risk alert identifying observations made during a series of examinations focused on industry practices and regulatory compliance for mutual funds and ETFs that may have an impact on retail investors. The staff's observations derived from examinations conducted on over 50 fund complexes covering more than 200 funds or series and nearly 100 investment advisers. The staff identified deficiencies or weaknesses in fund compliance programs and the oversight of those programs, fund disclosures to investors and fund governance practices. Based on these observations, the staff identified industry practices that funds may find helpful in their compliance programs.

**Fund Compliance Programs.** The staff identified the following examples of deficiencies or weaknesses related to the compliance programs of funds and their advisers and the oversight of those programs:

- failure to monitor and provide adequate oversight of portfolio management compliance, including oversight of fund investments;
- failure to provide adequate oversight of the valuation of portfolio securities, including establishing policies, procedures and controls over pricing vendor services;
- failure to provide adequate oversight over trading practices, including trade allocation, prohibited transactions and sharing of soft dollar commissions among clients;
- failure to oversee conflicts of interest between funds and their service providers, including index providers;
- failure to provide adequate oversight of the calculation of fees and expenses;
- failure to establish processes to review advertisements and sales literature;

- failure to establish policies, procedures and processes for monitoring and reporting accurate information to fund boards;
- failure to establish processes governing the board's annual review and approval of fund advisory agreements under Section 15(c) of the Investment Company Act of 1940;
- failure to complete annual reviews of funds' compliance programs and to assess the adequacy of annual CCO reports; and
- failure to adopt or maintain procedures for fund boards over delegated responsibilities.

**Fund Disclosures.** The staff identified the following examples of deficiencies or weaknesses related to funds' disclosure to investors:

- fund disclosures were inaccurate, incomplete or omitted from filings, including disclosures related to changes in investment strategies and potential conflicts of interest; and
- fund advertising and sales literature presented key information in a manner that was inaccurate or incomplete or omitted key information altogether.

**Staff Recommendations for Compliance Program and Disclosure Practices.** In conducting its examinations of funds and their advisers, the staff identified several industry practices that may be helpful in developing an effective compliance oversight program, including the following:

- reviewing compliance policies and procedures for consistency with fund practices;
- conducting periodic testing and reviews for compliance with disclosures and assessing efficacy in addressing conflicts of interest;
- ensuring compliance programs adequately address oversight of third-party vendors, including pricing vendors;
- adopting and implementing policies and procedures that ensure compliance with applicable regulations, align with terms and conditions of applicable exemptive orders and address undisclosed conflicts of interests;
- providing sufficient and accurate information to the board to allow for effective oversight and assessment of fund compliance programs;
- ensuring policies and procedures provide for adequate review, and where applicable, amendment of disclosure in fund reports and communications;
- amending disclosures to reflect actions taken by the funds' boards and updating funds' website disclosures concurrently with new or amended disclosures in fund reports and communications;
- reviewing and testing the accuracy and appropriateness of presentations of fund performance and expenses in fund reports and communications; and
- implementing processes that assess whether information provided to the board is accurate, including information related to fees, expenses and performance, and investment strategies and risks associated with those strategies.

The risk alert is available here.

## NEW RULES

# SEC Adopts Amendments to Filing Fee Disclosure and Payment Methods

On October 13, 2021, the SEC adopted amendments to modernize filing fee disclosure and payment methods for, among others, closed-end funds (other than interval funds) and business development companies (BDCs) filing on Forms N-2 and N-14. The amendments will eliminate the fee disclosure currently included on the facing sheets of most registration statements and instead will require that affected registrants include a filing fee exhibit with tables presenting all fee-related information in a structured data format. The

SEC also adopted amendments permitting payment of filing fees via Automated Clearing House (ACH) and debit and credit cards, and eliminated the option to pay filing fees by paper check or money order. The amendments generally will be effective on January 31, 2022; however, the amendments adding or eliminating payment options will be effective on May 31, 2022. Investment companies and BDCs filing on Forms N-2 and N-14 will become subject to the structuring requirements for filings they submit on or after July 31, 2025.

The adopting release is available here.

## PROPOSED RULES

### SEC Proposes Amendments to Electronic Filing Requirements and Re-Proposes Certain Amendments to Reports of Institutional Investment Managers

On November 4, 2021, the SEC announced proposed amendments to update electronic filing requirements that, if adopted, would require the electronic filing of certain documents. The SEC's proposal would also make technical amendments to certain forms to improve the readability of the data by requiring structured data reporting and removing outdated references. The proposed amendments are designed to promote more efficient storage, retrieval and analysis of submissions and to modernize the SEC's records management process.

Highlights from the SEC's proposal include:

- **Required electronic filings via EDGAR.** The SEC's proposal would require the electronic filing via EDGAR of (i) applications for orders under the Investment Advisers Act, thereby harmonizing the filing process with those for applications under the Investment Company Act, and (ii) confidential treatment requests for Form 13F reports filed by institutional investment managers that exercise investment discretion with respect to accounts holding $100 million or more in certain equity securities. Relatedly, the SEC is also proposing limited amendments to Form 13F (noted below), including to the instructions for confidential treatment requests, to conform with a June 2019 U.S. Supreme Court decision that overturned the standard for determining whether information is "confidential."
- **Amendments to Form 13F.** The SEC is also re-proposing certain amendments to Form 13F that were originally proposed in July 2020. Notably, the SEC is not proposing to raise the reporting threshold for Form 13F—an element of the July 2020 proposal. The proposed changes to Form 13F are limited in scope and include: (i) amendments to require each Form 13F filer to provide certain additional identifying information, (ii) certain technical amendments, and (iii) as noted above, modifications to the Form instructions.
- **Required electronic filings or submissions of Form ADV-NR.** The proposed amendments would also require the electronic submission of Form ADV-NR through the Investment Adviser Registration Depository (IARD) system—the same systems advisers use to file Form ADV. Filing Form ADV-NR is mandatory for non-resident general partners and non-resident managing agents of investment advisers and must be filed in connection with an adviser's initial Form ADV submission. Non-resident general partners and managing agents would also be required to amend their Form ADV-NR within 30 days whenever any information in the form becomes inaccurate.

The SEC's proposing release is available here. The public comment period will remain open for 30 days after publication of the proposing release in the Federal Register.

## GUIDANCE

### SEC Staff Issues Update Regarding Withdrawal and Modification of Staff Letters Relating to New Adviser Marketing Rule

On October 29, 2021, the staff of the SEC's Division of Investment Management issued an information update identifying the staff letters that have been withdrawn or

modified by the new "Marketing Rule" under the Investment Advisers Act of 1940. The Marketing Rule, adopted in December 2020, overhauls the traditional Advertising Rule under Rule 206(4)-1 and the Cash Solicitation Rule under Rule 206(4)-3 and consolidates each under a single new rule. The Marketing Rule represents a significant change to how investment advisers can market themselves and their products. Attorneys in Vedder Price's Investment Services Group have prepared a detailed summary of the Marketing Rule, which is available here.

The staff's information update confirms that investment advisers will no longer be able to rely upon the provisions of the withdrawn letters and will need to ensure compliance with the provisions of the modified letters, as applicable, by the Marketing Rule's November 4, 2022 compliance date.

The SEC staff's information update and list of withdrawn and modified letters is available here.

# Public Statements, Press Releases and Testimony

## SEC Chair Gary Gensler Provides Statement on Complex Exchange-Traded Products

On October 4, 2021, SEC Chair Gary Gensler issued a statement announcing that he had directed the SEC staff to review the risks of complex financial products and consider potential rulemaking proposals to address those risks. Specifically, Mr. Gensler focused on leveraged ETFs, which are designed to track a multiple of an underlying index, and inverse ETFs, which are designed to track the opposite of an underlying index, and the particular risks that these products may pose to individual investors.

Mr. Gensler noted that complex ETFs have long been a concern of the SEC, citing recent enforcement actions against financial professionals for recommending that retail investors buy and hold exchange-traded products designed for short-term trading and former SEC Chair Jay Clayton's stated concerns about the investor protection issues these products can pose. He cautioned that although the listing and trading of complex ETFs may be consistent with the Securities Exchange Act of 1934, as evidenced by the SEC's October 1, 2021 approval of two ETFs that will provide leveraged and inverse exposure to volatility futures, this does not mean that the products are appropriate for every investor. Mr. Gensler concluded by asserting his belief that rulemaking may provide strengthened investor protection.

Mr. Gensler's remarks are available here.

## Highlights from SEC Speaks 2021

The SEC held its annual "SEC Speaks" conference via Webex on October 12-13, 2021. The conference featured remarks from the Chair and several commissioners, discussions regarding current enforcement initiatives and enforcement priorities for the upcoming year and an update on litigation, judicial and legislative developments.

Highlights from this year's conference included substantive remarks from new SEC leaders, including Chair Gary Gensler and Director of the Division of Enforcement Gurbir S. Grewal, and discussions regarding modifications to the Wells process, the potential for requiring admission of liability as a settlement term in certain circumstances, the impact of the National Defense Authorization Act on the limitations period for disgorgement claims and various other developments in SEC -related litigation.

Attorneys in Vedder Price's Government Investigations & White Collar Defense group have prepared a detailed summary of the conference's highlights, which is available here.

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Vedder Price's Investment Services Group has received a 2020 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.