Investment Services Regulatory Update

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Monthly Version

VedderPrice

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New Rules, Proposed Rules, Guidance and Other Developments

PROPOSED RULES

SEC Proposes Oversight and Disclosure Requirements for Services Outsourced by Investment Advisers

On October 26, 2022, the SEC proposed a new rule that would require registered investment advisers to conduct due diligence prior to hiring a service provider to perform "covered functions" and to periodically monitor the performance of the service provider and reassess the retention of the service provider. Proposed amendments to Form ADV would require advisers to collect and report "census-type" information on these service providers, and amendments to the books and records rule would require advisers to keep and maintain records related to compliance with the new requirements.

Under the proposed rule, covered functions are functions or services that (1) are necessary for an investment adviser to provide its services in compliance with federal securities laws and (2) "if not performed or performed negligently, would be reasonably likely to cause a material negative impact" to the adviser's clients or to the adviser's provision of advisory services. Index providers are specifically referenced as potentially relevant service providers, although whether an index is relied on in the investment decision-making process or used for performance comparison would be relevant in determining whether the services concerned constitute a covered function. By way of example, compliance services would likely be covered, while marketing and soliciting would not. "[C]lerical, ministerial, utility, or general office functions or services" would not be considered covered functions. However, a third-party recordkeeper would be treated as a "service provider" performing a "covered function"—and the proposal would require enhanced oversight thereof, requiring advisers to obtain "reasonable assurances" that the recordkeeper will meet specific standards.

The proposed rule does not distinguish between third-party service providers and affiliated service providers. A service provider is defined as "a person or entity that: (1) performs one or more covered functions; and (2) is not a supervised person of the adviser." There is no exception under the proposed rule for service providers that are otherwise subject to regulation under other provisions of the federal securities laws.

The proposed due diligence element of the new rule would require an investment adviser "to reasonably identify and determine that it would be appropriate to outsource the covered function, that it would be appropriate to select the service provider, and once selected, that it is appropriate to continue to outsource the covered function." Once an adviser has engaged a service provider, the proposed rule would require periodic monitoring of the service provider's performance based on the due diligence requirements "with a manner and frequency such that the adviser can reasonably determine that it is appropriate to continue to outsource the covered function" to the service provider.

Comments on the proposed rule are due 30 days after the date of publication in the Federal Register or December 27, 2022, whichever is later.

The SEC's proposing release is available here, a related fact sheet is available here, and a related press release is available here.

NEW RULES

SEC Adopts Amendments to Streamline Mutual Fund and ETF Shareholder Reports and Revise Investment Company Advertising Rules

On October 26, 2022, the SEC adopted a new streamlined disclosure framework for open-end funds requiring "concise and visually engaging" shareholder reports highlighting key information, including a simplified expense presentation, performance information, portfolio holdings and certain fund statistics. Notably, mutual funds and ETFs that are registered on Form N-1A (i.e., open-end funds) will

be required to prepare individual shareholder reports for each fund and—in a change from the SEC's proposal—for each share class separately. Additionally, open-end funds will be excluded from the scope of the Investment Company Act's e-delivery rule, Rule 30e-3—which took effect on January 1, 2021—meaning that the new tailored shareholder reports must be mailed to shareholders, rather than just made available online, unless a shareholder affirmatively opts-in to electronic delivery. The amendments also include a revised definition of "appropriate broad-based securities market index" that will affect performance presentations in prospectuses—in addition to the streamlined shareholder report.

In addition to streamlining open-end fund shareholder reports, the SEC adopted amendments to investment company advertising rules to require that fee and expense presentations in registered investment company and business development company advertisements and sales literature be consistent with relevant prospectus fee table presentations and be reasonably current.

The amendments will become effective 60 days after publication in the Federal Register; funds will be required to comply with the amendments at the conclusion of an 18-month transition period following the effective date. Proposed changes to prospectus delivery requirements and prospectus risk and fee disclosure were not adopted.

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

SEC Amends Rules Regarding Preservation of Electronic Records and Recordkeeping Requirements for Broker-Dealers and Security-Based Swap Entities

On October 12, 2022, the SEC adopted amendments to modernize certain requirements for broker-dealers, security-based swap dealers (SBSDs) and major security-based swap participants (MSBSPs) regarding electronic recordkeeping, production of records and third-party recordkeeping services. The amendments were also designed to facilitate examinations of these entities by federal and state regulators.

The amendments impact the electronic recordkeeping requirements of Rule 17a-4 (applicable to broker-dealers, including those also registered as SBSDs and MSBSPs) and Rule 18a-6 (applicable to SBSDs and MSBSPs that are not also registered as broker-dealers (i.e., SBS entities)) under the Securities Exchange Act of 1934. As amended, the rules will require broker-dealers and non-bank SBS entities to use an electronic recordkeeping system that keeps records either in a non-rewritable, non-erasable format (often referred to as a "write once, read many" or "WORM" format), as currently required by Rule 17a-4, or in a fashion that complies with an "audit-trail alternative" under which a firm's recordkeeping system would preserve electronic records in a manner that permits recreation of an original record in the event it is altered, overwritten or erased.

Additional updates include the following:

- As amended, the electronic recordkeeping rules will require broker-dealers and SBS entities to produce electronic records in a reasonably usable electronic format that allows regulators to search and sort information.
- At present, Rule 17a-4 requires that a designated third party with access to the electronic storage media that a broker-dealer uses for record preservation make certain undertakings to furnish and provide access to information so stored to the SEC and state regulators upon request. As amended, the electronic recordkeeping rules will allow a broker-dealer or an SBS entity to designate either an executive officer or an unaffiliated third party to make the required undertakings.
- Amended Rule 17a-4 eliminates the requirement that a broker-dealer notify its designated examining authority (i.e., FINRA) before creating an electronic recordkeeping system.

The amendments will become effective 60 days after publication in the Federal Register. Compliance with the amendments will be required (1) six months after publication in the Federal Register for broker-dealers and (2) twelve months after publication in the Federal Register for SBSDs and MSBSPs.

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

GUIDANCE AND OTHER DEVELOPMENTS

SEC Staff Issues FAQ Relating to Consideration of DEI Factors in Adviser Recommendations

On October 13, 2022, the SEC staff issued guidance affirming that, under its fiduciary duty, an investment adviser may consider factors relating to diversity, equity and inclusion (DEI) when referring clients to other advisers—provided that the use of such DEI factors is consistent with the client's objectives, the scope of the relationship and the adviser's disclosures.

The SEC staff's guidance—in the form of a single question and answer—was issued in response to a July 2021 Asset Management Advisory Committee (AMAC) report addressing the "well-known and widely acknowledged" lack of gender and racial diversity in the asset management industry. In conjunction with the guidance, Commissioners Caroline A. Crenshaw and Jaime Lizárraga issued a joint statement noting that although the FAQ is a "step in the right direction," all of the AMAC's recommendations warrant "prompt consideration" by the SEC. Those recommendations include enhanced disclosures in SEC filings by advisers and investment companies intended to, among other things, provide transparency on issues of gender and racial diversity in the workforce and ownership ranks of advisers and on fund boards.

As to the staff's guidance, the FAQ explains that an adviser is required to have a reasonable belief that its advice is in the client's best interest based on the client's objectives and that establishing such a reasonable belief typically includes consideration of various factors. Therefore, an adviser's consideration of DEI factors in recommending or selecting other advisers is consistent with its fiduciary duty so long as the use of such factors aligns with a client's objectives, the scope of the relationship and the adviser's disclosures. Moreover, in the staff's view, the fiduciary duty does not mandate restricting adviser referrals to firms with certain specified characteristics, such as a minimum assets under management or track record length—criteria which, according to the AMAC report, could disproportionately exclude advisers owned by members of underrepresented demographic groups.

The FAQ is available here. The statement of Commissioners Crenshaw and Lizárraga is available here. The AMAC's July 2021 report and recommendations can be accessed here.

Investment Services Group Members

Chicago

Joseph M. Mannon, *Co-Chair* .... +1 (312) 609 7883
Cathy G. O'Kelly, *Co-Chair* .... +1 (312) 609 7657
Juan M. Arciniegas.......................... +1 (312) 609 7655
James A. Arpaia .... +1 (312) 609 7618
Deborah B. Eades .... +1 (312) 609 7661
Renee M. Hardt .... +1 (312) 609 7616
Randall M. Lending.......................... +1 (312) 609 7564
John S. Marten, *Editor*..................... +1 (312) 609 7753
Maureen A. Miller .... +1 (312) 609 7699
Nathaniel Segal, *Editor*.................... +1 (312) 609 7747
Jacob C. Tiedt, *Editor*...................... +1 (312) 609 7697
Cody J. Vitello................................. +1 (312) 609 7816
Jeff VonDruska................................ +1 (312) 609 7563
Junaid A. Zubairi............................. +1 (312) 609 7720
Heidemarie Gregoriev .... +1 (312) 609 7817
Adam S. Goldman............................ +1 (312) 609 7731
Kelly Pendergast Carr...................... +1 (312) 609 7719
Ryan Hajen .... +1 (312) 609 7763
Nicholas A. Portillo.......................... +1 (312) 609 7665
Mark Quade.................................... +1 (312) 609 7515
David W. Soden .... +1 (312) 609 7793
Christina V. West .... +1 (312) 609 7567
Jake W. Wiesen .... +1 (312) 609 7838
Kwashay (Shay) Wilkerson............... +1 (312) 609 7855

New York

Wayne M. Aaron............................. +1 (212) 407 7640
Jeremy I. Senderowicz .... +1 (212) 407 7740
Laure Sguario .... +1 (212) 407 7746

San Francisco

Rob Crea .... +1 (424) 204 9504

Washington, DC

Bruce A. Rosenblum, *Co-Chair*........ +1 (202) 312 3379
Marguerite C. Bateman................... +1 (202) 312 3033
W. Thomas Conner..........................+1 (202) 312-3331
Amy Ward Pershkow .... +1 (202) 312 3360
Kimberly Karcewski Vargo............... +1 (202) 312 3385
Elisa Cardano Perez .... +1 (202) 312 3030
John M. Sanders .... +1 (202) 312 3332

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Investment Services Group

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