Investment Services Regulatory Update

August 2022

Monthly Version

Vedder Price

New Rules, Proposed Rules, Guidance and Other SEC Developments

NEW RULES

SEC Adopts Amendments to Rules Governing Proxy Voting Advice, Rescinding Certain 2020 Amendments

On July 13, 2022, the SEC voted 3-2 along party lines to adopt amendments to the proxy rules under the Securities Exchange Act of 1934, rescinding certain aspects of rules regarding advice provided by proxy voting advice businesses (PVABs) that the SEC adopted in July 2020. Among other things, the 2020 rules added conditions in Rule 14a-2(b)(9)(ii) to exemptions from the proxy rules' information and filing requirements upon which PVABs often rely. Specifically, the 2020 rules required (1) PVABs to make their advice available to the companies that are the subject of their advice at or before the time that they made the advice available to their clients; and (2) clients of PVABs to be provided with a means of becoming aware of any written responses by registrants to proxy voting advice. Noting that "we are no longer persuaded that the potential benefits of those conditions sufficiently justify the risks they pose to the cost, timeliness, and independence of proxy voting advice," the SEC is rescinding the two conditions and related safe harbors and exclusions.

Other amendments adopted by the SEC include the following:

- **Rescission of 2020 Supplemental Proxy Voting Guidance.** The SEC's adopting release rescinds the supplemental guidance that the SEC issued to investment advisers about their proxy voting obligations—guidance which was prompted, in part, by the SEC's 2020 adoption of the conditions set forth in Rule 14a-2(b)(9)(ii).
- **Deletion of Note (e) to Rule 14a-9 (Liability Rule for Proxy Voting Advice)**. Concluding that its addition in 2020 had unnecessarily exacerbated legal uncertainty and confusion rather than reducing it, the SEC also approved the deletion of Note (e) to Rule 14a-9 under the Exchange Act which set forth examples of misleading material misstatements and omissions relating to proxy voting advice to clarify the application of the rule to proxy voting advice. The SEC's adopting release also discusses the Commission's views regarding the application of Rule 14a-9 to proxy voting advice, in particular with respect to statements of opinion.

The amendments will be effective September 19, 2022. The SEC's adopting release is available here.

PROPOSED RULES

SEC Proposes Amendments to Rules Governing the Exclusion of Shareholder Proposals in Proxy Statements

On July 13, 2022, the SEC issued proposed amendments to Rule 14a-8 under the Securities Exchange Act of 1934 governing the exclusion of shareholder proposals in a company's proxy statement that, if adopted, would allow a company to exclude shareholder proposals based on revised exclusion criteria. Currently, if a shareholder submits a proposal that satisfies the procedural requirements of Rule 14a 8, a company must include the proposal in its proxy statement unless one of 13 exclusion provisions applies. The SEC's proposal would amend three of the existing criteria—substantial implementation, duplication and resubmission. The proposed amendments are intended to improve the shareholder proposal process by providing greater transparency and consistency for shareholders and companies.

The SEC's proposed revision of exclusion criteria include:

- **Substantial Implementation Exclusion**. Under Rule 14a-8(i)(10), a company may exclude a shareholder proposal that has already been "substantially implemented" by the company. The amendment would allow for exclusion if the company has already implemented the "essential elements" of the proposal.

- **Duplication Exclusion**. Under Rule 14a-8(i)(11), a company may exclude a shareholder proposal that "substantially duplicates" a previously submitted proposal that will be included in the proxy statement for the same shareholder meeting. The amendment would specify that a proposal "substantially duplicates" another if it "addresses the same subject matter and seeks the same objective by the same means."

- **Resubmission Exclusion**. Under Rule 14a-8(i)(12), a company may exclude a shareholder proposal that "addresses substantially the same subject matter" as a proposal included in the company's proxy materials within the last five years if the most recent vote on the proposal took place within the last three years and the proposal received insufficient shareholder support. The amendment would align the duplication exclusion with the resubmission exclusion and revise the standard to allow a company to exclude a resubmitted proposal that "substantially duplicates" a prior proposal, i.e., the provision would allow exclusion if a proposal "addresses the same subject matter and seeks the same objective by the same means" as the prior proposal.

Comments on the proposal are due by September 12, 2022.

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

Litigation and Enforcement Proceedings

ENFORCEMENT PROCEEDINGS

SEC Settles Charges Against Insurance Company for Allegedly Misleading Disclosures About Variable Annuity Fees

On July 18, 2022, the SEC announced the settlement of an administrative proceeding brought against an insurance company for alleged violations of Section 17 of the Securities Act of 1933, which prohibits the offer or sale of securities by means of any untrue statement of material fact or any omission to state a material fact necessary in order to make statements made not misleading. Specifically, quarterly account statements provided to holders of certain variable annuity (VA) contracts allegedly did not include disclosure about separate account expenses (i.e., relating to, among other things, mortality and expense risks borne by the company) and portfolio operating expenses (i.e., underlying investment fund fees), which the SEC's order described as "the most significant fees that investors paid from the fees listed on the account statements."

Since at least 2016, the prospectus for the VA contracts disclosed that holders are charged several types of fees, including separate account expenses, portfolio operating expenses, administrative and transaction fees, and plan operating expenses. Quarterly statements for VA holders disclosed several line items on the front cover, including "Fees and Expenses," "Net Investment Portfolio Results" and "Total Account Value." Net Investment Portfolio Results and Total Account Value line items incorporated all fees paid because charges are reflected in annuity unit values. However, nothing in the quarterly account statement clarified that the Fees and Expenses line item included only administrative and transaction fees, which are generally incurred once per year and not on a quarterly basis. As a result, Fees and Expenses were often reported as $0.

The SEC also alleged that other sections of the quarterly account statements—such as the "Transaction Summary by Fund" and "Contribution and Fee Summary" sections—similarly failed to reflect or otherwise address separate account expenses and portfolio operating expenses. The SEC found that holders of the VA contracts continued to make purchase payments following receipt of "apparently all-inclusive" account statements in reliance on the insurance company's disclosures.

In settlement of the charges, without admitting or denying the findings set forth in the SEC's order, the insurance company agreed to cease and desist from violating Section 17 of the Securities Act of 1933, to revise the presentation of fee information in account statements and to pay a civil monetary penalty of $50 million.

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

SEC Settles Charges Against Adviser and CCO for Compliance Failures, Holding CCO Personally Liable

On June 30, 2022, the SEC issued an order detailing the settlement reached with an investment adviser and its principal and Chief Compliance Officer (CCO) relating to the alleged failure to adopt and implement required written compliance policies and procedures.

Under the adviser's compliance program, investment advisory representatives were required to disclose outside business activities to the adviser and to comply with the compliance policies of the broker-dealer used by the adviser in its advisory business. In the order, the SEC alleged several instances between December 2019 and June 2021 in which the CCO knew, or should have known, that the adviser's compliance program was inadequate in this regard. For example, in February 2020, the CCO is alleged to have received communications from an investment advisory representative about an outside business activity but did not require the representative to submit a formal reporting form, did not review whether the outside business activity presented any conflicts of interest and did not take sufficient steps to verify that the adviser or the representative disclosed the outside business activity to clients. In addition, despite receiving notices later in 2020 from the broker-dealer to review transactions conducted by the same representative involving transfers of client assets to the representative's outside business activity, the CCO allegedly did not conduct a review of the legitimacy of the transactions. This pattern is alleged to have continued despite the broker-dealer subsequently flagging that the representative in question took steps to avoid the broker-dealer's compliance program. Ultimately, following repeated warnings and notices, when the CCO reported the representative's outside business activity to the broker-dealer, the broker-dealer terminated its relationship with the adviser.

The SEC found that the adviser willfully violated Section 206(4) of the Investment Advisers Act of 1940 and Rule 206(4)-7 thereunder, which require that investment advisers adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act. Furthermore, the SEC found that the CCO willfully aided and abetted and caused the adviser to commit the foregoing violations.

In settlement of the charges, the adviser agreed to a censure, to cease and desist from future violations and to pay a $150,000 civil penalty. The CCO agreed to cease and desist from future violations, to refrain from acting in a supervisory or compliance capacity with any broker, dealer, investment adviser, municipal securities dealer, municipal adviser, transfer agent or nationally recognized statistical rating organization for five years and to pay a $15,000 civil penalty.

SEC Commissioner Hester Peirce issued a statement in response to the actions surrounding the order. She remarked that this was an opportunity to examine how a potential CCO liability framework might work in practice. She discussed several considerations to determine whether a CCO should be held personally responsible for a violation, particularly in distinguishing conduct that is "'debatably inappropriate' from conduct that is 'wildly inappropriate'—or, as it has been called in the past—'a wholesale failure' to carry out compliance responsibilities." These considerations include whether the CCO made a good-faith effort to fulfill his or her responsibilities, whether the failure related to a fundamental or central aspect of a well-run compliance program, whether the failure persisted over time, whether the failure related to a discrete specified obligation under securities laws or the firm's compliance program, whether the SEC issues rules and guidance on point related to the failure and whether an aggravating factor contributed to the seriousness of the CCO's conduct.

The SEC's order is available here.

Commissioner Peirce's statement is available here.

Public Statements, Press Releases and Testimony

PUBLIC STATEMENTS

SEC Division of Investment Management Director William Birdthistle Provides Remarks at PLI: Investment Management 2022

On July 26, 2022, William Birdthistle, Director of the SEC's Division of Investment Management, delivered remarks at PLI: Investment Management 2022 in Washington, D.C.

Mr. Birdthistle opened by discussing the SEC's tripartite mission—investor protection, capital formation, and the maintenance of fair, orderly and efficient markets. He emphasized the need to help investors better understand fund fees and opined that any expectation that investors should closely monitor complex fee arrangements and costs is not realistic. With respect to capital formation, he highlighted the benefits of proposed rules for private fund advisers that would prohibit certain activities that run contrary to the public interest and require additional disclosure and transparency. He noted that fund investors are not always aware of how funds vote portfolio shares and pointed to enhanced engagement through proxy voting as a potential avenue for increasing the voice of investors, as opposed to asset managers, in markets.

Mr. Birdthistle remarked on the cessation of the London Interbank Offered Rate (LIBOR). He noted the Division's work to help prepare advisers and funds for the upcoming transition away from LIBOR on June 30, 2023 but stated that more work is needed in the area of operational readiness. For example, he stated that asset managers and their lawyers should be mindful of LIBOR disclosure obligations and any valuation risks arising from the transition to an alternative reference rate. In an effort to avoid significant disruption, he stated that Division staff will continue to assess the preparedness of advisers and funds through their participation in examinations and outreach efforts.

Mr. Birdthistle discussed the impact of the European Union's Markets in Financial Instruments Directive (MiFID II) on the market for investment research in the United States and the European Union and the SEC staff's no-action letters in response to the changes. Among other things, MiFID II, which came into effect in 2018, prohibits European asset managers from using "soft dollars" to purchase investment research from broker-dealers. He discussed the no-action letters issued by the SEC staff in response to MiFID II, including the staff's position that it would not consider a broker-dealer that accepted compensation through certain arrangements required by MiFID II to be an investment adviser. He highlighted that this was a temporary position and not intended to be a permanent solution. Mr. Birdthistle stated that the Division staff does not intend to extend the temporary relief beyond its current expiration date on July 3, 2023 and does not expect to issue further assurances with respect to the status of broker-dealers accepting compensation under MiFID II arrangements. He also clarified that statements or positions in the no-action letters independent of the temporary adviser status position were not being rescinded.

Mr. Birdthistle concluded his remarks with a discussion on money market funds. He discussed the history of money market funds, including the growth of money market funds following the adoption of Regulation Q, the run on money market funds during the 2008 global financial crisis and the significant flows from prime money market funds into government money market funds in March and April 2020. He reflected on the high redemption rates experienced over the March and April 2020 period and the potential impact gates and fees had on redemptions. He highlighted swing pricing, which is used by European funds, as one potential solution to addressing future liquidity crises and welcomed comments on the use of swing pricing in the recent money market fund proposal.

A transcript of Mr. Birdthistle's remarks at PLI: Investment Management 2022 are 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.