Investment Services Regulatory Update

October 2023

Monthly Version

VedderPrice

New Rules, Proposed Rules, Guidance and Alerts

NEW RULES

SEC Adopts Amendments to Fund Names Rule, Broadening the Scope of Funds that Must Comply

On September 20, 2023, the SEC adopted amendments to the investment company names rule, Rule 35d-1 under the Investment Company Act of 1940. According to SEC estimates, the amendments will bring approximately 2,200 funds that did not previously have to comply with the rule within the scope of the rule, including its requirements for enhanced disclosure, quarterly compliance testing, Form N-PORT reporting and recordkeeping.

On September 27, 2023, attorneys in Vedder Price's Investment Services Group published an article regarding the amendments to the fund names rule. The complete article is available here.

SEC Adopts New Private Fund Adviser Rules

On August 23, 2023, the SEC adopted numerous reforms for private fund managers. These reforms represent the largest regulatory change for private fund managers since Dodd-Frank. The SEC's stated purpose is to bring "transparency" to the operation of private funds by, among other things, restricting or requiring disclosure of preferential terms such as those granted in side letters as well as requiring advisers to address conflicts of interest.

The new rule generally applies to managers of private funds but includes various nuances for SEC-registered, exempt-reporting advisers, state advisers and unregistered sponsors. The rule is also primarily limited to those advisers that manage "private funds." Private funds mean those relying on either Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940. Notably, this does not include funds relying on other exemptions such as is common for real estate or real assets funds. The SEC also excluded securitized asset products such as CLOs from the new rule.

On September 21, 2023, attorneys in Vedder Price's Investment Services Group published an article regarding the new private fund adviser rules. The complete article is available here.

PROPOSED RULES

SEC Proposes Significant Form and Rule Amendments for the Registration of Index-Linked Annuities

On September 29, 2023, the SEC proposed significant form and rule amendments to establish a tailored registration form for index-linked annuities, as directed by Congress under the Registered Index-Linked Annuities Act of 2022 (RILA Act). Unlike variable annuity contracts, for which the SEC has adopted specific registration statement forms (i.e., Forms N-3 and N-4), insurance companies currently register offerings of registered index-linked annuities (RILAs) on registration statements on Securities Act of 1933 Forms S-1 or S-3. The market for RILAs has grown significantly in recent years. The SEC's proposal would require RILA issuers to register offerings on amended Form N-4, the form used by most variable annuities, with proposed amendments designed to provide investors with disclosure tailored to RILAs, while building on the SEC's layered disclosure framework. Other proposed amendments to Form N-4 would apply to all issuers that use that form.

Highlights of the SEC's proposal include the following:

- Form N-4 would be amended to facilitate enhanced investor understanding of the features of RILAs and variable annuities. Proposed changes, which would apply to all users of Form N-4, include moving the Key Information Table (KIT) to follow disclosures of general information about the contract, reworking the KIT to follow a question-and-answer format, enhancing disclosure requirements regarding the consequences of early withdrawals, and broadening the range of required KIT disclosures about contract restrictions.

- Form N-4 would be amended to require various disclosures specific to the features and risks of RILAs. These changes would include requirements for tailored disclosure about early withdrawal charges; contract adjustments; "implicit ongoing fees" relating to cap rates, participation rates and other upside limitations; risks relating to index-linked options; and the reservation of rights by the sponsoring insurance company to add or remove index-linked options, change the features of index-linked options and substitute the index of an index-linked option during its crediting period, as well as disclosure regarding the index crediting methodology.
- RILAs would also have an option to use a summary prospectus, subject to certain conditions.

Comments on the proposal are due 30 days after publication in the Federal Register or November 28, 2023, whichever is later. The SEC also invited retail investors to provide feedback on annuities and RILAs by submitting a "Feedback Flyer," a link to which is provided in the press release announcing the proposal.

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

GUIDANCE AND ALERTS

SEC Staff Issues Risk Alert Regarding the Selection and Scope of Adviser Examinations

On September 6, 2023, the staff of the SEC's Division of Examinations issued a risk alert describing the staff's risk-based approach in selecting registered investment advisers to examine and in determining the scope of areas of examination. The staff stated that its risk-based selection approach is dynamic and adapts to market conditions, industry practices and investor preferences. Due to the size and variety of advisers, the staff stated that it could select an adviser for examination to evaluate risks at the particular firm, to respond to events posing risks to investors or the broader market, or to assess how firms adapt to new regulations. The staff noted its use of technology to collect and analyze industry-wide and firm-level data to identify risks and better understand a firm's business in an examination. The staff noted that although the information shared in the risk alert is intended to highlight risks and issues relating to examinations that the staff has identified, the risk alert may also assist firms in their supervision, compliance and risk management efforts and may inform changes that firms can make to strengthen those efforts.

In the risk alert, the staff identified the following factors in its process for selecting advisers and determining the scope of areas for examination:

- The staff stated that it may select advisers for examination based on factors such as the firm's risk characteristics; a tip, complaint or referral; the staff's interest in a particular risk area, which may be reflected in the staff's annual examination priorities; and the scope of the advisory services the firm provides.
- The staff stated that it selects advisers for examination in consideration of firm-specific risk factors related to a adviser's business activities, conflicts of interest and regulatory history, including, among other things, observations from prior examinations, supervisory concerns such as the disciplinary history of advisory personnel, business activities that may create conflicts of interest, time elapsed since the adviser's initial registration or last examination, material changes in firm leadership or other personnel, media reports or third-party data and whether the firm has access to client assets or presents gatekeeper or service provider compliance risks.
- The staff stated that once an adviser is selected for examination, the staff will conduct additional risk assessment to determine the scope of the examination, which will vary depending on the firm's business model, associated risks and the reason for the examination. The staff stated that it reviews advisers' operations, disclosures, conflicts of interest and compliance practices regarding core areas such as custody and safekeeping assets, valuation, portfolio management, fees and expenses, and trade execution. In an examination, the staff requests documents and information from these areas to understand the adviser's conflicts of interest and its risks and related controls and to test the effectiveness of the adviser's compliance policies and procedures to monitor, mitigate and manage risks and conflicts of interest.

The staff also attached a typical initial information request to the risk alert to inform advisers regarding the documents and other information the staff typically requests in an examination.

The risk alert is available here.

OTHER

SEC Issues New Strategic Plan for Diversity, Equity, Inclusion, and Accessibility

On September 18, 2023, the SEC announced the agency's Diversity, Equity, Inclusion, and Accessibility (DEIA) Strategic Plan for fiscal years 2023 through 2026. The SEC stated that a commitment to DEIA is critical to accomplishing its three-part mission: to protect investors; to maintain fair, orderly and efficient capital markets; and to facilitate capital formation. The SEC's stated DEIA vision includes the integration of DEIA as an agency priority to support an inclusive culture in which people from diverse backgrounds can share ideas that impact both the SEC's workplace and the communities the agency serves. The plan lays out various DEIA goals, priorities and actions built around three main pillars—people, culture and mission.

For example, under the plan's goals regarding people and with respect to diversity, the SEC established a priority to recruit staff with the right mix of skills and expertise, including from under-recognized groups, in its mission-critical occupations. Among the actions the plan identified to achieve that priority are the use of outreach and recruitment strategies to draw from all segments of society and the development and maintenance of strategic partnerships with historically Black colleges and universities, Hispanic-serving institutions, women's colleges and colleges that typically serve majority-minority populations, as well as professional organizations serving under-recognized groups. The plan will be reviewed annually to assess progress, with a full update to the plan to be initiated every four years.

The SEC's DEIA strategic plan is available here, and a related press release is available here.

Litigation and Enforcement Matters

ENFORCEMENT DEVELOPMENTS

SEC Settles Enforcement Proceedings Against Nine Advisers for Alleged Marketing Rule Violations

On September 11, 2023, the SEC announced the settlement of administrative proceedings brought against nine registered investment advisers for disseminating hypothetical performance returns on their public websites without adopting required policies and procedures required by Rule 206(4)-1 under the Investment Advisers Act of 1940, known as the Marketing Rule.

Among other things, the Marketing Rule prohibits advisers from using hypothetical performance information in advertising material unless they have adopted and implemented policies and procedures to ensure that the information is relevant to the likely financial situation and investment objectives of the advertisement's intended audience. Hypothetical performance information includes the performance of model portfolios and backtested performance returns derived from applying a strategy to historical data from periods when the strategy was not actually employed. In addition, Rule 204-2(a)(11) under the Advisers Act requires advisers to maintain copies of all advertising material disseminated directly or indirectly. The SEC alleged that all nine advisers failed to adopt and implement the requisite policies and procedures, resulting in the dissemination of hypothetical performance information to mass audiences through their websites. In addition, the SEC alleged that two of the advisers failed to maintain the required copies of their advertising material.

The SEC found that the advisers willfully violated Section 206(2) of the Advisers Act, which makes it unlawful for an adviser to engage in fraud or deceit upon any client or prospective client, Section 206(4) of the Advisers Act, which makes it unlawful for any adviser to engage in fraudulent, deceptive or manipulative business practices, as well as the Marketing Rule and, as applicable, the related recordkeeping rule. Without admitting or denying the allegations, the advisers agreed to cease and desist from future violations, to be censured, to comply with certain undertakings and to pay civil monetary penalties ranging from $50,000 to $175,000.

In announcing the settlements, Gurbir S. Grewal, Director of the SEC's Division of Enforcement, stated that, "[b]ecause of their attention-grabbing power, hypothetical performance advertisements may present an elevated risk for prospective investors whose likely financial situation and investment objectives don't match the advertised investment strategy … It is therefore crucial that investment advisers implement policies and procedures to ensure their compliance with the [Marketing Rule]."

The SEC's press release announcing the settlements can be found 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.