Investment Services Regulatory Update

February 2023

Monthly Version

VedderPrice

New Rules, Proposed Rules, Guidance and Other Developments

GUIDANCE & ALERTS

SEC Staff Bulletin Cautions Funds and Boards About the Risk of Cross-Subsidization from “Differential Advisory Fee Waivers”

On February 2, 2023, the staff of the SEC’s Division of Investment Management issued a bulletin cautioning mutual funds, their boards of directors and their legal counsel about potential implications under the Investment Company Act of 1940 when fee waiver and expense reimbursement arrangements cause different advisory fees to be charged to different share classes of the same fund—referred to by the staff as “differential advisory fee waivers.” Specifically, the staff warned that a differential advisory fee waiver may constitute a “prohibited means of cross-subsidization between classes.”

Section 18(f)(1) of the 1940 Act generally prohibits a registered open-end investment company, or a series thereof, from issuing any “senior security,” which is defined, in relevant part, as “any stock of a class having priority over any other class as to distribution of assets or payment of dividends.” Section 18(i) generally requires that every share issued by a fund “be a voting stock and have equal voting rights with every other outstanding voting stock.” Rule 18f-3 under the 1940 Act provides a limited exemption from Sections 18(f)(1) and 18(i) that permits a fund, subject to certain conditions, to issue multiple classes of voting stock representing interests in the same portfolio that have different shareholder servicing or distribution arrangements, that provide their holders with certain different voting rights and that bear certain different expenses (generally other than advisory and custody fees and other expenses related to the management of the fund’s assets). Among other things, reliance on the rule is subject to a requirement that the fund’s board of directors adopt a written plan setting forth the separate arrangement and expense allocation of each class and any related conversion features or exchange privileges.

The staff’s bulletin emphasizes that although Rule 18f-3 expressly allows a fund’s fees and expenses to be waived or reimbursed by the adviser or another service provider, the SEC, in the 1995 adopting release for Rule 18f-3, warned that fee waivers and reimbursements were not intended to become “*de facto* modifications of the fees provided for in advisory or other contracts so as to provide a means for cross-subsidization between classes.” Moreover, the SEC’s adopting release directed boards to monitor the use of waivers or reimbursements to guard against cross-subsidization, a responsibility the SEC described as consistent with a board’s “oversight of the class system and its independent fiduciary obligations to each class.”

The SEC staff’s bulletin asserts that advisory fees charged to shareholders of all classes of a mutual fund should generally be the same percentage amount. In the staff’s view, “differential advisory fee waivers that are long-term or permanent, or effectively long-term or permanent, and are not substantiated with a clearly defined temporal purpose, could … present a means of cross-subsidization between classes in contravention of Rule 18f-3.”

The staff acknowledges that whether a differential advisory fee waiver constitutes prohibited cross-subsidization is a “facts-and-circumstances determination” that the fund’s board, in consultation with the adviser and counsel, should consider making and documenting after considering all relevant factors. The staff provided an example in which, in the fund-of-funds context, a board may be able to conclude that a long-term advisory fee waiver for one share class but not for other share classes does not constitute cross-subsidization; in the example, such a conclusion would be possible if the board were to find that (1) shareholders of the class subject to the waiver pay fees to the adviser at the investing fund level and (2) those fees, when added to the advisory fees paid by the waived class, after giving effect to the waiver, are at least equal to the amount of advisory fees paid by the other classes.

For funds that already have differential advisory fee waivers in place, the staff recommends that boards consider whether the arrangement allows for cross-subsidization, whether the steps the board takes to monitor against cross-subsidization are effective and whether alternative fee arrangements may be appropriate. The staff also advises funds to consider the extent to which the board's consideration of these issues may require disclosure to shareholders.

The staff's bulletin is available here.

OTHER DEVELOPMENTS

PCAOB Issues New HFCA Act Determination Report for Chinese and Hong Kong Auditors

On December 15, 2022, the Public Company Accounting Oversight Board (PCAOB) announced that it was able to inspect and investigate issuer audit engagements of PCAOB-registered accounting firms headquartered in the People's Republic of China (PRC) and Hong Kong in a manner consistent with the Holding Foreign Companies Accountable Act (HFCA Act). As a result, China-based issuers will have continued access to U.S. capital markets while compliance is maintained.

The HFCA Act, an amendment to the Sarbanes-Oxley Act of 2002, was signed into law in December 2020 to address concerns over audit inspections of China-based companies trading in the United States. The HFCA Act requires the SEC to identify all issuers subject to the periodic reporting requirements of the Securities Exchange Act of 1934 whose audited financial reports are prepared by an accounting firm that is located in a foreign jurisdiction and that the PCAOB is unable to inspect due to a position taken by an authority in that jurisdiction. If the PCAOB is unable to inspect the issuer's auditor for three consecutive years, the issuer will be prohibited from having its securities listed for trading on a U.S. exchange or otherwise traded in over-the-counter markets subject to the jurisdiction of the SEC.

The PCAOB's new determination report follows an August 2022 Statement of Protocol signed by the PCAOB with the China Securities Regulatory Commission and the Ministry of Finance of the PRC. Pursuant to the Statement of Protocol, the PCAOB and the PRC created a framework for compliance with the HFCA Act that allows the PCAOB sole discretion to select audit firms for review, provides PCAOB inspectors and investigators access to complete audit work papers and gives the PCAOB the ability to directly interview and take testimony from audit personnel.

From September to November 2022, PCAOB staff conducted inspections and investigations in China and Hong Kong to verify that the access provided by the Statement of Protocol was sufficient to establish compliance with the HFCA Act. As a result of this access, the PCAOB voted to vacate its previous 2021 determinations of noncompliance with the HFCA Act. The determination of the PCAOB reflects its ability to access audit firms, not the quality of audits conducted, as the PCAOB has preliminarily identified numerous deficiencies at the firms examined. These deficiencies will be referred for further investigation and potential sanctions and be made public as part of the final inspection reports, to be released later in 2023. Regular inspections of China- and Hong Kong-based auditing firms by the PCAOB are planned for early 2023 and beyond, with new investigations being initiated as needed.

The full PCAOB 2022 HFCAA Determination Report is available here. The PCAOB's fact sheet is available here. A statement from PCAOB Chair Erica Y. Williams is available here, and a related statement from SEC Chair Gary Gensler is available here.

Regulatory Agenda Highlights Potential and Pending SEC Rulemaking Topics

On January 4, 2023, the Office of Information and Regulatory Affairs—part of the Office of Management and Budget, within the Executive Office—released the latest Unified Agenda of Regulatory and Deregulatory Actions, reporting on potential rulemaking topics that administrative agencies, including the SEC, will consider in the short and long term. These topics include several areas of interest to funds, advisers and financial institutions. The topics are categorized in one of three rulemaking stages: proposed rule, final rule and long-term actions.

Proposed Rule Stage. Matters identified in the proposed rule stage include the following:

- digital engagement practices for investment advisers and broker-dealers—rules related to use of predictive data analytics, differential marketing and behavioral prompts;

- the listing and trading of exchange-traded products (ETPs) on national securities exchanges relating to a 2015 SEC request for comment;
- outsourcing by investment advisers and rules related to advisers' oversight of third-party service providers;
- registered investment companies' fees and fee disclosure—a topic that first appeared in the spring 2022 regulatory agenda but has not yet resulted in any SEC release;
- open-end fund liquidity and dilution management;
- custody rules for investment advisers;
- Regulation D and Form D amendments, including updates to the accredited investor definition; and
- registrant disclosures regarding human capital management.

Final Rule Stage. Matters identified in the final rule stage include the following:

- shortening the standard settlement cycle;
- amendments to the definition of dealer;
- electronic recordkeeping requirements for broker-dealers, security-based swap dealers and major security-based swap participants;
- Form PF and reporting requirements for investment advisers to private funds;
- investment adviser disclosures and governance relating to cybersecurity risks;
- rules relating to transparency, conflicts of interest and certain other matters involving private fund advisers, and documentation of adviser compliance reviews;
- enhanced disclosures by investment advisers and funds about environmental, social and governance (ESG) practices;
- investment company names rule;
- money market fund reforms;
- tailored shareholder reports, treatment of annual prospectus updates for existing investors and improved fee and risk disclosure for mutual funds and ETFs, as well as fee information in investment company advertisements; and
- enhanced reporting of proxy votes by funds and reporting on executive compensation votes by institutional investment managers.

Long-Term Actions. Matters identified in the "long-term actions" stage of rulemaking include the following:

- the role of certain third-party service providers and the implications for the asset management industry; and
- the regulatory regime for transfer agents.

The SEC's rule list for topics identified in the final rule or proposed rule stage is available here; the "long-term actions" list is available here. SEC Chair Gary Gensler issued a statement in connection with the release of the regulatory agenda.

Litigation and Enforcement Proceedings

ENFORCEMENT MATTERS

Taking Broad View of Omission Liability, SEC Settles Enforcement Action Against Pricing Service Provider

On January 23, 2023, the SEC announced the settlement of administrative proceedings brought against Bloomberg Finance L.P., a privately held financial, software, data and media company, for alleged violations of Section 17(a)(2) of the Securities Act of 1933, which provides for liability for material misstatements and omissions in the offer or sale of securities. Bloomberg's alleged materially misleading omission was its apparent failure to disclose to customers of its independent pricing service, BVAL, that valuations for certain thinly-traded fixed-income securities could, in certain circumstances, be largely driven by a single data input, such as a broker quote. According to the SEC's order, since BVAL's customers include mutual funds, asset managers and hedge funds, which may use BVAL's prices when valuing fixed income positions and making offers and sales of securities, Bloomberg's alleged omission about its valuation methodologies "impacted offers and sales of certain securities … in violation of Section 17(a)(2) of the Securities Act." Finding the foregoing reasoning to be flawed, Commissioners Hester M. Peirce and Mark T. Uyeda issued a statement objecting to the enforcement action and expressing the view that the statements at issue were not made in the offer or sale of securities.

Without admitting or denying the charges, Bloomberg agreed, in settlement of the charges, to pay a civil monetary penalty in the amount of $5,000,000 and to cease and desist from future violations of Section 17(a)(2). The SEC's order notes that Bloomberg's remedial efforts, including its voluntary retention of an outside expert and publication of additional disclosures regarding its valuation methodologies, were considered by the SEC in determining to accept the settlement offer.

In an accompanying press release, Osman Nawaz, Chief of the Division of Enforcement's Complex Financial Instruments Unit stated, "[t]his matter underscores that we will hold service providers, such as Bloomberg, accountable for misrepresentations that impact investors."

The SEC's administrative order is available here and the accompanying press release is available here. The statement of Commissioners Peirce and Uyeda is 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.