



Investment Services Regulatory Update

April 2023
Monthly Version

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New Rules, Proposed Rules, Guidance and Alerts

PROPOSED RULES

SEC Reopens Comment Period for Investment Adviser and Investment Company Cybersecurity Proposals in Connection with Other Cyber and Data Privacy Related Proposals

On March 15, 2023, the SEC reopened the comment period on proposed rules and amendments related to cybersecurity risk management and cybersecurity-related disclosure for registered investment advisers, registered investment companies and business development companies that were proposed on February 9, 2022. The initial comment period ended on April 11, 2022. A previous Vedder Price summary of the proposals is available [here](#). Comments on the proposals are now due by May 22, 2023.

The SEC reopened the comment period in conjunction with the release of proposed new cybersecurity risk management rules for broker-dealers, clearing agencies, transfer agents and other market participants and proposed amendments to Regulation S-P. Proposed amendments to Regulation S-P would, among other things, require “covered institutions”—including funds and registered investment advisers—to develop, implement and maintain written policies and procedures for an incident response program that is reasonably designed to detect, respond to and recover from unauthorized access to or use of customer information. The proposed incident response program procedures would require notification to individuals whose sensitive customer information was, or is reasonably likely to have been, accessed or used without authorization. Comments on both the proposed amendments to Regulation S-P and

the proposed cybersecurity risk management rules for broker-dealers and other market participants are due by June 5, 2023.

Various SEC materials are available as follows:

- Reopening of Comment Period for Cybersecurity Risk Management for Investment Advisers, Registered Investment Companies and Business Development Companies

[Proposing Release \(reopening of comment period\)](#)

[Proposing Release \(initial release\)](#)

[Fact Sheet](#)

- Cybersecurity Risk Management Rule for Broker-Dealers, Clearing Agencies, Major Security-Based Swap Participants, the Municipal Securities Rulemaking Board, National Securities Associations, National Securities Exchanges, Security-Based Swap Data Repositories, Security-Based Swap Dealers and Transfer Agents

[Proposing Release](#)

[Fact Sheet](#)

- Regulation S-P: Privacy of Consumer Financial Information and Safeguarding Customer Information

[Proposing Release](#)

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GUIDANCE AND OTHER DEVELOPMENTS

SEC Staff Issues 2023 Examination Priorities

On February 7, 2023, the staff of the SEC’s Division of Examinations issued its examination priorities for 2023. The examination priorities included a number of areas of particular interest to regulated entities including registered investment advisers, broker-dealers and registered funds, including those described below.

• **Notable New and Significant Focus Areas.**

- *Adviser Marketing Rule (Rule 206(4)-1)*. The staff will assess whether advisers have adopted and implemented written policies and procedures reasonably designed to prevent violations of the rule, whose compliance date was November 4, 2022, and

whether they have complied with the substantive requirements of the rule.

- **Fund Derivatives Rule (Rule 18f-4).** The staff will assess whether registered funds have adopted and implemented compliance policies and procedures reasonably designed to prevent violations of the derivatives rule, whether funds have adopted and implemented a derivatives risk management program, the effectiveness of the derivatives risk management program, board oversight of derivatives and the accuracy and completeness of derivatives-related disclosure.
- **Fund Valuation Rule (Rule 2a-5).** The staff will assess board oversight of valuation matters at registered funds; the designation of the valuation designee; and any changes to valuation methodologies, compliance policies and procedures, governance practices, vendor oversight and reporting and recordkeeping made in response to the new rule.
- **Advisers to Private Funds.** The staff will focus on conflicts of interest, the calculation and allocation of fees and expenses, marketing rule compliance, the use of alternative data and insider trading policies and procedures, and compliance with the Custody Rule (Rule 206(4)-2). The staff will also focus on advisers to private funds with specific risk characteristics.
- **Regulation Best Interest and Adviser Fiduciary Duties.** The staff will continue to prioritize examinations of broker-dealers for compliance with Regulation Best Interest and examinations of advisers for compliance with applicable fiduciary duties. Among other issues, examiners will review the sufficiency of conflict of interest disclosure and whether firms have client agreements that inappropriately waive or limit a firm's standard of conduct. The staff will also continue to prioritize compliance with Form CRS requirements.
- **ESG Investing.** The staff will continue focusing on ESG disclosures and practices, including in particular at advisers and funds that hold themselves out as having ESG or sustainable strategies.
- **Information Security and Operational Resiliency.** The staff noted the elevated risk environment given market events, geopolitical concerns and a proliferation of cybersecurity attacks. Given these risks, the staff will continue to focus on cybersecurity and the safeguarding of customer records and information at all regulated entities, with an added focus on issues associated with the use of third-party vendors.

- **Crypto Assets and Emerging Financial Technology.** The staff will focus on broker-dealers and advisers offering products related to crypto assets and those providing services involving emerging financial technologies such as mobile app and automated investment tools, and trading platforms, including "robo advisers."

- **Registered Investment Advisers.** In addition to focus areas from previous years (e.g., custody, valuation, portfolio management, brokerage and execution, conflicts and fee-related issues), the staff will review policies and procedures for retaining and monitoring electronic communications and selecting and using third-party service providers.

- **Registered Investment Companies.** In addition to assessing compliance programs and governance practices, disclosures and the accuracy of reporting, the staff will focus on whether advisers to registered funds are fulfilling their fiduciary duties, including with respect to the receipt of compensation for services and other material payments made by funds. In this regard, the staff will evaluate fund boards' processes for assessing and approving advisory and other fund fees, in particular for funds with weaker relative performance versus peers.

The staff will also focus on registered funds with specific characteristics, such as funds on turnkey platforms; mutual funds converted to ETFs; non-transparent ETFs (to assess compliance with applicable exemptive relief); funds that invest in loans, including leveraged loans and collateralized loan obligations; small complexes that have experienced significant personnel attrition; volatility-linked or single-stock ETFs; and funds that have not previously been examined.

- **Broker-Dealers.** In addition to compliance and supervisory programs, the safeguarding of client assets, trading practices and related conflicts of interest and issues specific to municipal and other fixed-income securities and OTC and microcap securities, the staff will focus on any involvement by broker-dealers in the distribution of unregistered securities.
- **National Securities Exchanges, Security-Based Swap Dealers, Municipal Advisors and Transfer Agents.** The staff noted continued areas of focus in general, and cited added focus on transfer agents that service certain types of issuers and assets (including microcap and crypto assets) and those that use emerging technologies to perform their transfer agency services.

- **Anti-Money Laundering.** The staff noted that examinations of AML programs and monitoring of and compliance with OFAC and Treasury-related sanctions by broker-dealers and registered funds have heightened importance as a result of the geopolitical environment and the increased imposition of international sanctions.
- **London Interbank Offered Rate Transition.** The staff stated that it would continue its assessment of broker-dealers' and advisers' preparation for the transition away from LIBOR, currently scheduled for mid-2023.

In closing, the staff stated that while it would allocate significant resources to its stated examination priorities, it would also conduct examinations and devote resources to address new or emerging risks, products and services, market events and investor concerns.

The Division of Examinations' 2023 examination priorities are available [here](#).

SEC Staff Issues Risk Alert for Newly Registered Advisers

On March 27, 2023, the SEC's Division of Examinations issued a risk alert relating to examinations of newly registered investment advisers. Noting that conducting examinations of newly registered advisers has been a stated examination priority since 2013, the staff issued the risk alert to discuss the typical areas of focus in examinations of newly registered advisers as well as certain observations from those examinations.

The staff stated that examinations of newly registered advisers allow for early engagement between the staff and advisers, permitting the staff to provide information about the examination program, conduct preliminary risk assessments, discuss the advisers' operations and risks and promote compliance. The staff stated that examinations frequently focus on whether newly registered advisers have identified and addressed conflicts of interest, whether they have provided full and fair disclosure to clients that allow clients to provide informed consent and whether they have adopted effective compliance policies and procedures. The risk alert included a description of the scope of an examination of a newly registered adviser, noting that the examination typically focuses on (1) general information about the adviser's business and operations; (2) demographic and other information about client

accounts; (3) information about the adviser's compliance program, risk management practices and internal controls; (4) information to allow the staff to test for compliance in areas such as portfolio management and trading; and (5) communications the adviser uses to inform or solicit new or and existing clients.

The risk alert also includes a summary of staff observations from examinations of newly registered advisers, including the following:

- The staff observed newly registered advisers with compliance policies and procedures that did not adequately address sources of risk to the firm, such as portfolio management and fee billing; that failed to include procedures to enforce certain policies (e.g., a policy to seek best execution without procedures to evaluate the quality of trade execution); and that were not followed by advisory personnel due either to a lack of awareness or to an inconsistency between stated policies and procedures and the firm's actual business practices and operations.
- The staff observed advisers that performed annual compliance reviews that did not address the adequacy of compliance policies and procedures or their effectiveness of implementation. In this regard, the staff noted (1) advisers with off-the-shelf compliance manuals not tailored to their particular businesses; (2) advisers that devoted insufficient resources to the compliance function; (3) advisers with undisclosed and unmitigated conflicts of interest relating to advisory personnel with multiple roles and responsibilities; (4) advisers that performed inadequate oversight of outsourced functions; and (5) advisers without business continuity plans or succession plans.
- The staff observed advisers with disclosure documents that included misstatements or omissions and that were untimely filed and updated. These included disclosures about advisers' fees and compensation, business and operations, investment strategies, trading practices, account reviews, disciplinary history, websites and social media accounts, and conflicts of interest.
- The staff observed advisers with marketing materials that appeared to include materially false or misleading information, including with respect to the experience and credentials of advisory personnel, third-party rankings and performance. The staff also observed advisers that could not substantiate factual claims in marketing materials.

The risk alert is available [here](#).

Litigation and Enforcement Matters

ENFORCEMENT DEVELOPMENTS

SEC Orders Affiliated Investment Advisers to Repay Clients for Alleged Breaches of Fiduciary Duties

On February 27, 2023, the SEC announced the settlement of administrative proceedings brought against two affiliated investment advisers for alleged breaches of their fiduciary duties.

According to the SEC's order, from at least September 2015 through 2022, the advisers, one acting as sub-adviser to accounts managed by the other, breached their fiduciary duty to provide clients with full and fair disclosure about conflicts of interest. Specifically, the advisers failed to disclose (1) compensation the sub-adviser received based on client transaction fees; (2) revenue sharing payments an affiliated broker-dealer received and shared with the sub-adviser relating to client assets invested in cash sweep accounts; (3) 12b-1 fees received by the same affiliated broker-dealer from client investments in certain mutual fund share classes, including when lower-cost share classes that did not pay 12b-1 fees were available for purchase; and (4) conflicts of interest related to revenue the sub-adviser and affiliated broker-dealer received based on the rate of margin interest charged to clients. The SEC also noted in the order that, although eligible to do so, the advisers did not self-report their affiliated broker-dealer's receipt of 12b-1 fees to the SEC as part of the Division of Enforcement's Share Class Selection Disclosure Initiative.

Additionally, the SEC alleged that the advisers breached their duty of care, including their duty to seek best execution, in connection with evaluating transaction fees charged to clients, selecting cash sweep account

options and recommending that clients invest in share classes that pay 12b-1 fees, while failing to evaluate whether those share classes best served client interests when lower-cost share classes of the same funds were available. The SEC further alleged that the advisers failed to adopt and implement written compliance policies and procedures reasonably designed to prevent the foregoing alleged violations.

The SEC found that the advisers had willfully violated Section 206(2) of the Investment Advisers Act, which makes it unlawful for any adviser to engage in a transaction, practice or course of business that operates as a fraud or deceit upon a current or prospective client; Section 206(4) of the Advisers Act, which makes it unlawful for any adviser to engage in any act, practice or course of business that is fraudulent, deceptive or manipulative; and Rule 206(4)-7 under the Advisers Act, which requires advisers to adopt and implement written compliance policies and procedures reasonably designed to prevent violations of the Advisers Act and related rules. The advisers consented to cease and desist from future violations, censure and compliance with certain undertakings and agreed to pay disgorgement of \$608,251, pre-judgment interest of \$105,251 and civil penalties totaling \$180,000.

In an accompanying statement, SEC Commissioners Hester M. Peirce and Mark T. Uyeda asserted that the finding set forth in the order that the advisers violated their duty to seek best execution by placing certain clients in higher-cost mutual fund share classes that charged 12b-1 fees when less expensive share classes were available created a "novel regulatory interpretation" of the law, noting that the SEC cited no legal authority for the finding. Commissioners Peirce and Uyeda argued that the duty to seek best execution is inapplicable to purchases of mutual fund shares because those shares are required to be sold and redeemed at a price based on the net asset value calculated after receipt of the order and, separately, that 12b-1 fees are paid out of the assets of a mutual fund on an ongoing basis.

The order is available [here](#) and the accompanying press release is available [here](#). The statement of Commissioners Peirce and Uyeda is available [here](#).

Public Statements, Press Releases and Testimony

PUBLIC STATEMENTS

SEC Division of Investment Management Director William Birdthistle Provides Remarks at ICI Investment Management Conference

On March 20, 2023, William Birdthistle, Director of the SEC's Division of Investment Management, delivered remarks at the ICI Investment Management Conference in Palm Desert, California. In his remarks, Mr. Birdthistle discussed three broad trends, how the Division's recent rulemaking could address these trends and the risks the trends could pose to investors and markets.

The first trend Mr. Birdthistle highlighted was technological advancement, including specific developments such as distributed ledgers and decentralized finance, artificial intelligence and machine learning. He noted the technology-related risks posed by cybersecurity threats and data breaches, prompting the recent rulemaking proposals for cybersecurity programs at investment advisers and funds and the recent proposed amendments to Regulation S-P that would require advisers to adopt policies and procedures for responding to the unauthorized access or use of customer information. He also referenced the recent proposal to amend the investment adviser custody rule (Rule 206(4)-2) that, in part, was intended to address technological advancement in the area of custody.

The second trend Mr. Birdthistle discussed was changing demographics. He noted a wave of retirements in the Baby Boomer generation, all of whose members will be at least 65 years old by 2030. As one generation leaves the work force and another joins, he emphasized the importance of providing clear disclosure about investment products and called attention to the recent adoption

of streamlined annual and semi-annual shareholder reports for mutual funds and ETFs and the proposed amendments to the SEC's names rule (Rule 35d-1). He also noted demographic change within the asset management industry. He cited the SEC's Office of Minority and Women Inclusion, which provides entities with a "Diversity Assessment Report" tool that may be used to assess a firm's diversity policies and practices, and referenced the staff FAQ published in 2022 regarding the consideration of diversity, equity and inclusion factors in the recommendation and selection of investment advisers.

The third trend Mr. Birdthistle observed was the rapid growth in the asset management industry in recent decades. He presented data from a 2022 ICI survey indicating that 52.3% of U.S. households own mutual funds, compared to 25% in 1990 and less than 6% in 1980. He also referenced an Investment Adviser Association study that reported a 47% increase in the number of individuals served by investment advisers between 2019 and 2021. In this regard, he noted the heavy reliance asset management firms place on third-party service providers and highlighted the recent rule proposal relating to the oversight by investment advisers of outsourced functions (Rule 206(4)-11) and related amendments to Form ADV and recordkeeping requirements.

A transcript of Mr. Birdthistle's remarks at the 2023 ICI Investment Management Conference is available [here](#).

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Investment Services Group

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