Investment Management Legal and Regulatory Update

Godfrey & Kahn Investment Management Team Members Responsible for this Update:

Christopher M. Cahlamer

414.287.9338
ccahlamer@gklaw.com

Ellen R. Drought

414.287.9517
edrought@gklaw.com

Susan M. Hoaglund

262.951.7136
shoaglund@gklaw.com

Kristen A. Irgens

414.287.9308
kirgens@gklaw.com

Emma L. Janicki

414.287.9614
ejanicki@gklaw.com

Godfrey & Kahn Employee Benefits Team Member Contributing to this Update:

Michael W. Taibleson

414.287.9384
mtaibleson@gklaw.com

LATEST DEVELOPMENTS: FUNDS

Final Rules

SEC Adopts Major Changes to Shareholder Reports and Amendments to Investment Company Advertising Rules

On October 26, 2022, the SEC, in a unanimous vote, adopted rule and form amendments that make major changes to the required content of open-end fund shareholder reports and delivery requirements. The SEC also adopted amendments to the advertising rules under the Investment Company Act for open-end and closed-end funds. The changes to the fund disclosure framework were initially proposed in 2020 under previous SEC Chairman Jay Clayton. The new rules finalize two of the disclosure changes proposed in 2020. The SEC staff is continuing discussions with market participants with respect to its earlier proposals relating to fund prospectus disclosure requirements.

Tailored Shareholder Reports

The amendments will require mutual funds and exchange-traded funds (ETFs) to provide shareholders with “concise and visually engaging” shareholder reports that are designed to allow retail investors to better assess and monitor their fund investments. The shareholder report could be as short as three pages in length and will include a more simplified presentation of fees and expenses and performance information. The report will also contain a graphical representation of portfolio holdings (as it currently does), a summary of material changes that occurred during the reporting period and required fund statistics. The changes are intended to address concerns regarding shareholder reports that have gotten increasingly lengthy and complex over the years and allow for a “layered” disclosure approach, borrowing from summary prospectuses, which provide key information in a streamlined and user-friendly format with more detailed information available online. Fund complexes will need to prepare separate shareholder reports for each series of a fund complex and for each share class of a fund; this differs from the current approach where fund complexes are permitted to include multiple series, and multiple share classes of each series, in a single report. The new shareholder reports will need to be filed and tagged using Inline XBRL structured data language so that they provide machine-readable information that retail investors and others can use to “more efficiently access and evaluate investments.”

Under the final rule, the schedule of investments and other financial and performance information must continue to be prepared and filed with the SEC on Form N-CSR semi-annually. The new shareholder reports are also required to be filed on Form N-CSR. Form N-CSR must be available on a fund’s website and delivered free of charge, upon request, to financial professionals and other investors seeking more in-depth information.

The amendments also change Form N-1A's definition of "appropriate broad-based securities market index" to require funds to compare their performance to an index that represents the overall domestic or international equity or debt markets, as appropriate. Funds may continue to compare their performance to other indexes, including narrower indexes, as an additional comparison point. This amendment will impact performance presentations in both prospectuses and shareholder reports.

Exclusion of Funds from the Scope of Rule 30e-3 under the Investment Company Act

The amendments exclude open-end funds from the scope of Rule 30e-3 with respect to electronic delivery of shareholder reports. Rule 30e-3 currently allows funds to provide shareholders with a paper notice of the online availability of shareholder reports rather than mailing the entire shareholder report. Under the amendments, funds will be required to mail the new concise shareholder reports to fund shareholders, unless a shareholder affirmatively consents to e-delivery. The SEC's rationale for narrowing Rule 30e-3 was to help ensure all fund shareholders realize the anticipated benefits of the new disclosure framework, which the SEC believes represents a more effective way for shareholders to use and access fund information, while still saving costs.

Fund Fees and Expenses Information in Investment Company Act Advertisements

The final rule amendments impact open-end and closed-end funds' presentations of fund fees and expenses information disclosed in fund advertisements and sales literature. Specifically, the fees and expenses information presentations must be current and consistent with the fee table presentations contained in a fund's prospectus. Further, the fees and expenses information contained in fund advertisements and sales literature must include standardized fee and expense figures and adhere to certain prominence requirements. The amendments are intended to ensure that the presentation of fees and expenses in fund marketing materials is not materially misleading.

Compliance Date and Other Information

In a change from the original rule proposal, which is discussed in more detail in our October 2020 Regulatory Update, the SEC did not take final action with respect to proposed Rule 498B under the Securities Act, which would continue to require funds to furnish a prospectus to new investors but funds would not be required to annually deliver prospectus updates to investors after their initial investment. This proposal received mixed reviews from commentators, and the SEC is taking additional time to further consider such commentary. The SEC also did not adopt proposed amendments regarding prospectus fee and risk disclosures.

The effective date for the rule and form amendments is January 24, 2023. Funds will be required to comply with the amendments 18 months after the effective date, which is July 24, 2024.

Sources: SEC Adopts Amendments to Modernize Fund Shareholder Reports and Promote Transparent Fee- and Expense-Related Information in Fund Advertisements, SEC Press Release 2022-193 (Oct. 26, 2022), available here; Tailored Shareholder Reports for Mutual Funds and Exchange-Traded Funds; Fee Information in Investment Company Advertisements, Release No. IC-34731 (Oct. 26, 2022), available here; Shareholder Reports for Mutual Funds and ETFs; Fee Information in Investment Company Advertisements, SEC Fact Sheet (Oct. 26, 2022), available here; Chair Gary Gensler, Statement on Final Rule Amendments Regarding Shareholder Reports (Oct. 26, 2022), available here.

SEC Adopts Rules to Enhance Proxy Voting Disclosure by Funds and Require Disclosure on "Say-on-Pay" Votes for Institutional Investment Managers

On November 2, 2022, in a 3-2 vote, the SEC adopted final amendments to Form N-PX under the Investment Company Act and new Rule 14Ad-1 under the Exchange Act. The form amendments are intended to enhance the information funds currently provide on Form N-PX about their proxy votes. The new rule will require institutional investment managers to report on Form N-PX how they voted proxies with respect to executive compensation (i.e., "say-on-pay" votes), implementing a requirement added by the Dodd-Frank Act of 2010.

Form N-PX Amendments

Funds are required to file their proxy voting record for the 12-months ended June 30 on Form N-PX on an annual basis. The current rules do not require standardized disclosure regarding proxy votes, which makes it difficult for investors and other market participants to analyze and compare votes across fund complexes. The amendments to Form N-PX will require funds to:

- Identify proxy proposals using the same language as disclosed in an issuer's proxy card and in the same order as presented in such proxy card.

- Categorize proxy votes so that investors are able to focus on the topics they find important. Such categories include, among others, director elections, extraordinary transactions, "say-on-pay," shareholder rights and defenses, and the environment or climate.

- Disclose (1) the number of shares voted or instructed to be voted and how such shares were voted, and (2) the number of shares loaned (but not recalled to vote). At their option, funds may provide additional information regarding the considerations as to what led to a decision not to recall securities on loan.

- Provide Form N-PX disclosure separately by series for fund complexes that offer multiple series.

- File reports using XML structured data language, which is intended to make data easier to analyze and compare.

"Say-on-Pay" Voting Disclosure for Institutional Investment Managers

New Rule 14Ad-1 will require institutional investment managers that are subject to Section 13(f)'s reporting requirements (i.e., managers that exercise investment discretion over securities with an aggregate value of at least $100 million) to annually report on Form N-PX how they voted proxies relating to "say-on-pay" votes. The Dodd-Frank Act included a provision mandating institutional investment managers to disclose how they voted on "say-on-pay" matters when they exercised voting power over the securities – in other words, when such managers have both the ability to vote (or direct the voting of) a security and influence the voting decision. In order to avoid duplicative disclosure when a manager exercises voting power on behalf of a fund or when more than one manager exercises voting power over a security, the SEC will allow managers (or managers and funds) to rely on joint reporting provisions. Investment managers that do not manage funds, and thus previously were not required to file Form N-PX, will be required to report votes on Form N-PX if they exercise voting power with respect to "say-on-pay" votes. Even in the case where a manager has a policy not to vote on "say-on-pay" matters and did not exercise voting power over any securities that held "say-on-pay" votes during a reporting period, the new rule will require filing a report on Form N-PX that no votes were cast.

The effective date for the amendments and new rule is July 1, 2024. As such, the form amendments and new rule will be effective for votes occurring on or after July 1, 2023 and reflected in the Form N-PX for the 12-month period ended June 30, 2024, which is required to be filed by August 31, 2024.

Sources: SEC Adopts Rules to Enhance Proxy Voting Disclosure by Registered Investment Funds and Require Disclosure of "Say-on-Pay" Votes for Institutional Investment Managers, SEC Press Release 2022-198 (Nov. 2, 2022), available here; Enhanced Reporting of Proxy Votes by Registered Management Investment Companies; Reporting of Executive Compensation Votes by Institutional Investment Managers, Release No. IC-34745 (Nov. 2, 2022), available here; Amendments to Form N-PX and Say-on-Pay Vote Disclosure, SEC Fact Sheet, available here.

Proposed Rules

SEC Proposes Swing Pricing and Changes to Liquidity Risk Management

On November 2, 2022, in a 3-2 vote, the SEC proposed major amendments to the liquidity rule (Rule 22e-4), the forward pricing rule (Rule 22c-1), and certain reporting and disclosure forms under the Investment Company Act. The SEC proposed the amendments to better prepare funds for stressed market conditions and to mitigate the dilution of shareholders' investments, citing the liquidity challenges and significant redemptions experienced by the industry during the market stress in March 2020. The proposed amendments, if adopted, would require funds (as applicable) to: (1) use swing pricing; (2) implement a "hard close" for investor transactions; (3) revise their liquidity risk management programs; and (4) more frequently file information on Form N-PORT.

The proposed swing pricing and hard close requirements have made waves across the mutual fund industry because of the far-reaching implications the amendments would have on the pricing and distribution of mutual funds, as well as concerns about costs and the competitive impact on mutual funds. The proposing release acknowledged that if the new rules are adopted, "investors may reduce their investment in open-end funds, making open-end funds less competitive with other types of investment vehicles, such as closed-end funds (e.g., interval funds), ETFs or CITs." The

SEC also discussed challenges in estimating costs on open-end funds in the cost-benefit analysis, noting, among other reasons, that "we cannot predict . . . the number of investors that would exit mutual funds and instead invest in other fund structures . . ." as a result of the new swing pricing framework.

Swing Pricing

Under a rule adopted in 2016, open-end funds are currently permitted to use swing pricing as a tool to manage liquidity. As defined in the proposing release, swing pricing "is the process of adjusting the price above or below a fund's NAV per share to effectively pass on the costs stemming from shareholder purchase or redemption activity to the shareholders associated with that activity." The proposing release noted that since the rule was adopted, "no U.S. funds have implemented swing pricing" but "swing pricing has been a commonly employed anti-dilution tool in Europe." Citing the market events in March 2020 and the perceived need for additional tools to limit dilution, the SEC is proposing to make swing pricing mandatory for funds (other than money market funds and ETFs) as well as amend the existing swing pricing rule. Under the proposed amendments to Rule 22c-1, funds would be required to adjust their NAV depending on whether a fund has net purchases or net redemptions. Specifically, the proposal would require funds to apply a "swing factor" (an estimate of transaction costs, including spread costs, brokerage commissions and market impact) when a fund experiences net redemptions or when net purchases exceed 2% of a fund's assets.

Fund boards would be required to appoint a swing pricing administrator, which may not be a portfolio manager. Swing pricing administrators would be required to determine a fund's swing factor by making good-faith estimates (backed by data) of transaction costs of buying or selling a pro rata amount of a fund's portfolio (also referred to as a "vertical slice"). The intention of swing pricing is to effectively pass the costs stemming from fund flows to the investors that are engaging in purchase and redemption activity, rather than passing such costs onto existing fund shareholders thereby diluting their interests. The proposal also would require fund boards to initially approve swing pricing policies and procedures and receive an annual written report from the swing pricing administrator.

Mandatory "Hard Close"

The proposal would mandate a "hard close" for funds (other than money market funds and ETFs), which means that an investor's purchase or redemption order for fund shares would be eligible to receive the current day's price only if the fund, its transfer agent or a registered clearing agency receives the order before the time the fund calculates its NAV (generally 4:00 p.m., Eastern time). A hard close is necessary to facilitate swing pricing in order for funds to receive timely fund flow information. The release noted that "mutual funds need sufficient net order flow information to determine whether to apply a swing factor, and the size of that swing factor, before they finalize that day's price." In addition, the SEC believes a hard close will improve order processing and help prevent late trading of fund shares.

Currently, the vast majority of trade orders are placed with fund intermediaries, rather than directly with a transfer agent, and intermediaries may not transmit final orders before the time a fund calculates its NAV (and typically transmits them later in the evening or even the next morning). Under the proposed rule, intermediaries would need to submit orders much earlier than they currently do in order to receive the current day's NAV. The SEC acknowledged that the proposed hard close requirement "may affect all market participants sending orders to relevant funds, including broker-dealers, registered investment advisers, retirement plan recordkeepers and administrators, banks, insurance companies, and other registered investment companies."

Liquidity Risk Management Rule Amendments

Rule 22e-4 currently requires a fund to classify its holdings in one of four liquidity buckets based on the number of days the fund reasonably anticipates the investment could be convertible to cash in current market conditions without significantly impacting the investment's market value. The proposed amendments to Rule 22e-4 would eliminate the "less liquid" investment category and require that investments currently categorized as "less liquid" be categorized as "illiquid." Investments falling under the "less liquid" category include securities with longer settlement times, such as certain bank loans and foreign securities.

The proposal would also require funds to assume the sale of a stressed trade size instead of the current requirement of assuming the sale of a reasonably anticipated trade size (or RATs) in current market conditions. Further, the proposal would require funds to establish a highly liquid investment minimum by requiring funds to maintain a minimum amount of "highly liquid" investments of at least 10% of their net assets.

Form N-PORT Amendments

The proposed amendments would also require certain funds (other than money market funds, closed-end funds and ETFs organized as unit investment trusts) to file Form N-PORT on a monthly, rather than quarterly basis. These funds would be required to report their portfolio holdings within 30 days after month-end, with the reports becoming publicly available 60 days after month-end.

Reactions to the Proposal

The Investment Company Institute (ICI) issued a statement stating that swing pricing is "unnecessary," and that this proposal could have "an enormous negative impact on more than 100 million Americans who invest in funds." The ICI noted the fact that mutual funds are highly liquid products and were able to survive the problems experienced during the March 2020 market events (and questioned the staff's March 2020 findings). The ICI's statement further provided that, if swing pricing were adopted, there would be "insurmountable operational hurdles" and risks to confusing investors by changing mutual funds' longstanding practice of striking an NAV (generally) at 4:00 p.m. Eastern Time. Commissioner Hester Peirce released a statement opposing the release of the proposal because "nobody has the bandwidth to consider properly a proposal that would fundamentally alter the way open-end funds operate, how investors interact with them, and the infrastructure surrounding them" – especially with a short comment period of 60 days.

The comment period for the proposal closes on February 14, 2023. As of December 31, 2022, the SEC has received nearly 1,000 comments and several meetings with the Division of Investment Management staff have been held.

Sources: SEC Proposes Enhancements to Open-End Fund Liquidity Framework, SEC Press Release 2022-199 (Nov. 2, 2022), available here; Open-End Fund Liquidity Risk Management Programs and Swing Pricing; Form N-PORT Reporting, Release No. IC-34746 (Nov. 2, 2022), available here; Open-End Fund Liquidity Risk Management and Swing Pricing, SEC Fact Sheet, available here; David Isenberg, SEC Floats Mandatory Swing Pricing for Mutual Funds, IGNITES (Nov. 2, 2022), available by subscription; Swing Pricing Proposal from SEC Could Severely Harm Savers, ICI (Nov. 2, 2022), available here; Statement from Commissioner Hester Peirce, Closing Act: Statement on Proposed Open-End Liquidity Risk Management Programs and Swing Pricing; Form N-PORT Reporting (Nov. 2, 2022), available here.

LATEST DEVELOPMENTS: ADVISERS

SEC Proposes New Requirements for Adviser Oversight of Service Providers

On October 26, 2022, the SEC, in a 3-2 vote, proposed Rule 206(4)-11 under the Advisers Act to prohibit advisers from outsourcing certain services or functions without first meeting minimum requirements. If adopted as proposed, advisers would be required to:

- Conduct due diligence prior to engaging a "service provider" (defined below) to perform a "covered function" (defined below);
- Periodically monitor the service provider's performance and reassess the selection of the service provider to perform the covered function; and
- Maintain books and records related to its due diligence and monitoring activities.

Service Providers

"Service provider" would be defined as a person or entity that: (1) performs one or more covered functions; and (2) is not a supervised person of the adviser. The proposed rule does not make a distinction between third-party service providers and affiliated service providers.

Covered Functions

"Covered functions" would be defined as services or functions that are: (1) necessary to provide advisory services in compliance with the federal securities laws; and (2) if not performed or performed negligently, would be reasonably likely to cause a material negative impact on the adviser's clients or on its ability to provide investment advisory services. Clerical, ministerial, utility, and general office functions or services would be excluded from the definition of a covered function. Likewise, third-party marketing and solicitation services are not covered services because they are not used to provide investment advice to clients.

The determination of what is a covered function (i.e., whether an adviser must oversee a service provider pursuant to the proposed rule) would depend on facts and circumstances as the proposed rule is meant to cover functions or services that are necessary for a particular adviser to provide investment advisory services. Covered functions could include the provision of investment guidelines, creating and providing custom indexes, creating and providing model portfolios, regulatory compliance, providing trading desk services, and valuation.

Due Diligence and Monitoring

An adviser would be required to reasonably identify and determine through due diligence that it would be appropriate to outsource the covered function, that it would be appropriate to select the service provider performing the covered function, and once selected, that it is appropriate to continue to outsource the covered function, by evaluating at least six elements:

1. The nature and scope of the covered function;
2. Potential risks resulting from the service provider performing the covered function, including how to mitigate and manage such risks;
3. The service provider's competence, capacity, and resources necessary to perform the covered function;
4. The service provider's subcontracting arrangements that would be material to the performance of the covered function;
5. Reasonable assurance from the service provider that it will coordinate with the adviser for purposes of the adviser's compliance with federal securities laws; and
6. Whether the service provider is able to provide a process for the orderly termination of the performance of the covered function.

Policies and Procedures

Although the proposed rule does not explicitly require new policies and procedures related to service provider oversight, policies and procedures to address compliance with the proposed rule would be required under existing Rule 206(4)-7 under the Advisers Act, which mandates the adoption of policies and procedures to prevent violations of the Advisers Act.

Form ADV

The SEC proposed related amendments to Form ADV, Part 1A. Specifically, advisers would be required to disclose whether they have outsourced any covered function to a service provider and provide identifying information about the outsourcing relationship, including classifying the covered function using the following categories: (1) adviser/subadviser; (2) client servicing; (3) cybersecurity; (4) investment guideline/restriction compliance; (5) investment risk; (6) portfolio management (excluding adviser and subadviser); (7) portfolio accounting; (8) pricing; (9) reconciliation; (10) regulatory compliance; (11) trading desk; (12) trade communication and allocation; (13) valuation; and (14) other.

Enhanced Oversight of Third-Party Record Keepers

The SEC also proposed amendments to Rule 204-2 under the Advisers Act, the recordkeeping rule, to require an adviser that relies on a third party to maintain books and records to comply with a comprehensive oversight framework, consisting of due diligence, monitoring and recordkeeping elements, effectively subjecting recordkeeping to the same diligence required of an outsourced covered function. In addition, an adviser relying on a third party for recordkeeping functions would be required to obtain reasonable assurances from the third party regarding their recordkeeping processes and systems, among other items.

Resistance to the Proposal

Two SEC commissioners voted against the proposal. Commissioner Mark Uyeda criticized the proposed rule as "problematic because it creates significant interpretive challenges." He continued, "almost any function outsourced by an investment adviser could trigger the numerous oversight functions set forth in the proposed rule. What is a chief compliance officer to do?" Commissioner Hester Pierce asked "What precisely is the problem this proposal is trying to correct?"

The ICI has recommended that the SEC abandon the proposal. They oppose the proposal because, among other reasons: (1) there is no evidence that the proposal is needed; and (2) current law, including advisers' fiduciary duty, appropriately addresses the SEC's concerns. Ignites recently reported that the SEC "may be reconsidering its controversial mandates governing fund industry outsourcing."

Sources: SEC Proposes New Oversight Requirements for Certain Services Outsourced by Investment Advisers, SEC Press Release 2022-194 (Oct. 26, 2022), available here; Outsourcing by Investment Advisers, Release No. IA-6176 (Oct. 26, 2022), available here; Outsourcing by Investment Advisers, SEC Fact Sheet, available here; Commissioner Mark T. Uyeda, Statement on Proposed Rule Regarding Outsourcing by Investment Advisers (Oct. 26, 2022), available here; Commissioner Hester M. Pierce, Outsourcing Fiduciary Duty to the Commission: Statement on Proposed Outsourcing by Investment Advisers (Oct. 26, 2022), available here; Comment Letter of the Investment Company Institute (Dec. 23, 2022), available here; Joe Morris, SEC May Be At Work On New Outsourcing Rule, IGNITES (Jan. 5, 2023), available by subscription.

SEC Risk Alert Highlights Weaknesses in Identity Theft Prevention Programs

On December 5, 2022, the SEC Division of Examinations (Division) published a risk alert providing observations from recent examinations of advisers and broker-dealers related to compliance with Regulation S-ID (also known as the Identity Theft Red Flags Rule), which requires firms that offer or maintain covered accounts to develop and implement an identity theft prevention program.

Regulation S-ID applies to SEC-regulated entities that qualify as financial institutions or creditors and maintain covered accounts, such as: (1) broker-dealers that offer margin or custodial accounts; (2) investment companies that offer check-writing privileges or allow individuals to make wire transfers to other parties; and (3) advisers that can direct transfers or payments from individual accounts to third parties based on the individual's instructions or as the individual's agent.

The risk alert follows SEC settlements with one broker-dealer and two dual registrants (firms registered as both a broker-dealer and adviser) in July 2022 for deficiencies in their programs to prevent customer identity theft in violation of Regulation S-ID. Without admitting or denying the SEC's findings, each firm agreed to cease and desist from future violations. In aggregate, the firms paid $2.55 million in penalties.

Identification of Covered Accounts

The Division staff provided the following examples of deficiencies observed during recent examinations related to the identification of covered accounts:

- Failure to assess whether accounts were "covered accounts";
- Failure to identify new and additional covered accounts (e.g., failing to reassess new accounts and omitting online accounts);
- Failure to maintain documentation of analysis of covered accounts; and
- Failure to conduct risk assessments.

Establishment of an Identity Theft Prevention Program

The Division staff observed the following issues with respect to the establishment of written programs:

- Programs not tailored to the business (e.g., a template with fill-in-the-blanks that had not been completed); and
- Programs that did not cover all required elements of Regulation S-ID.

Required Elements of the Program

The Division staff observed the following instances in which programs lacked required elements.

Identification of Red Flags. The staff observed firms that did not appear to have reasonable policies and procedures to identify relevant red flags. Specifically, the Division staff observed firms that:

- Did not include any identified red flags in their program; or
- Failed to identify red flags specific to their covered accounts, and instead listed examples from Appendix A of Regulation S-ID regardless of the flags' relevance to the firms' covered accounts; and
- Did not have a process or did not follow existing procedures to evaluate actual experiences with identity theft in order to determine if additional red flags should be added to their programs.

Detect and Respond to Red Flags. The Division staff observed firms that relied on pre-existing policies and procedures (e.g., anti-money laundering procedures) that were not designed to detect and respond to red flags.

Periodic Program Updates. In recent examinations, the Division staff observed:

- Some firms did not update their identified red flags after making substantial changes to the ways in which their clients open and access their accounts, including providing account access not only through local offices, but also through online customer portals; and
- Firms that had gone through reorganizations or business changes, such as mergers or acquisitions of other financial firms, but had failed either to incorporate these new business lines into their existing program or to approve a new program for these new business lines.

Administration of the Program

The Division staff observed firms that did not provide for the continued administration of their programs as required by Regulation S-ID. For example, firms:

- Did not appear to provide sufficient information to the board or designated senior management through periodic reports;
- Had inadequate training; and
- Failed to evaluate controls of service providers.

The Division staff encourages broker-dealers and advisers to consider whether any improvements are necessary to their identity theft prevention practices, policies and procedures.

Sources: Observations from Broker-Dealer and Investment Adviser Compliance Examinations Related to Prevention of Identity Theft Under Regulation S-ID (Dec. 5, 2022), available here; SEC Charges JPMorgan, UBS, and TradeStation for Deficiencies Relating to the Prevention of Customer Identity Theft, SEC Press Release 2022-131 (July 27, 2022), available here.

SEC Staff FAQ Relating to Adviser Consideration of DEI Factors

The SEC staff released an FAQ in October 2022 stating that an adviser's consideration of diversity, equity and inclusion (DEI) factors in recommending other advisers to, or selecting other advisers for, clients is consistent with an adviser's fiduciary duty. The use of DEI factors must be consistent with a client's objectives, the scope of the relationship and the adviser's disclosures. An adviser's fiduciary duty does not limit the adviser to making such a recommendation based solely on assets under management or length of track record.

Source: Staff FAQ Relating to Investment Adviser Consideration of DEI Factors (Oct. 13, 2022), available here.

DOL Issues Final ESG Investing and Proxy Voting Rules

On November 22, 2022, the U.S. Department of Labor (DOL) issued new rules, "Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights," that allow plan fiduciaries to consider climate change and other environmental, social and governance (ESG) factors when they select retirement investments and exercise shareholder rights, such as proxy voting. After considering feedback from a wide range of stakeholders, the DOL concluded that rules issued in 2020 during the prior administration unnecessarily restrained plan fiduciaries' ability to weigh ESG factors when choosing investments.

The final rules will be effective January 30, 2023, except with respect to the proxy voting provisions, which have a delayed applicability date of December 1, 2023.

ERISA Fiduciary Standards

Title I of the Employee Retirement Income Security Act of 1974 (ERISA) establishes standards that govern the operation of private-sector employee benefit plans. ERISA requires that plan fiduciaries act prudently and diversify plan investments to minimize the risk of large losses. ERISA also requires fiduciaries to act solely in the interest of the plan's participants and beneficiaries, and for the exclusive purpose of providing benefits to participants and beneficiaries and defraying reasonable plan expenses. ERISA plan fiduciaries are required to focus on a plan's financial returns. The DOL has long recognized that ERISA does not preclude fiduciaries from making investment decisions that reflect ESG considerations and choosing economically targeted investments (investments designed to consider collateral benefits – i.e. benefits that are generated in addition to the financial returns earned by a plan investment) and that the fiduciary act of managing employee benefit plan assets includes the management of voting rights.

The DOL's Prior Guidance on Economically Targeted Investments (ETI) and ESG Investing

The DOL has long held the position that ERISA fiduciaries may not sacrifice investment returns or assume greater investment risks to promote collateral social policy goals. However, for many years, the DOL maintained that ESG investments are compatible with ERISA's fiduciary obligations if the expected rate of return is commensurate with alternative investments under the so-called "all things being equal" test or the "tiebreaker" standard.

Exercising Shareholder Rights

The DOL has long taken the position that a plan fiduciary has a duty to monitor decisions made by investment managers regarding proxy voting and recognized that fiduciaries may engage in shareholder activities intended to monitor or influence corporate management if the fiduciary concludes that, after considering the costs involved, there is a reasonable expectation that such shareholder activities – including deciding to vote or not to vote proxies – will enhance the value of a plan's investments.

Recent Evolution of DOL ESG/ETI Guidance

The DOL published the current rules in 2020, which require plan fiduciaries to select investments based solely on consideration of "pecuniary factors" and prohibit a fund from serving as a qualified default investment alternative (QDIA) if the fund includes even one non-pecuniary consideration in its investment objectives or principal investment strategies. The DOL reexamined the current rules beginning in 2021, which included an informal outreach to interested stakeholders – including asset managers, labor organizations and other plan sponsors, consumer groups, service providers, and investment advisers.

The Final Rules

The new rules clarify the application of ERISA's fiduciary duties of prudence and loyalty to selecting investments, including selecting QDIAs, and exercising shareholder rights such as proxy voting.

The final rules, among other provisions, amend the current rules to:

- Eliminate the "pecuniary/non-pecuniary" terminology, which some stakeholders believe created investor confusion and a "chilling effect on appropriate integration of climate change and other ESG factors in investment decisions." The DOL stated that "numerous commenters indicated that the current regulation puts a thumb on the scale against ESG factors, and chills fiduciaries from considering any ESG factors even when they are relevant to a risk-return analysis."
- Clarify that a fiduciary's determination regarding an investment must be based on factors that the fiduciary reasonably determines are relevant to a risk and return analysis, including the economic effects of climate change and other ESG factors.
- Remove stricter rules for QDIAs, so that the same standards apply to QDIAs as to other investments.
- Permit fiduciaries to consider collateral benefits as a tiebreaker.
- Remove provisions setting out specific monitoring obligations with respect to the use of investment managers or proxy voting firms. The final rules address such monitoring obligations more generally.
- Replace the requirement that competing investments be indistinguishable based on pecuniary factors alone before fiduciaries can turn to collateral factors to break a tie with a standard that requires the fiduciary to conclude prudently that competing investments equally serve the financial interests of the plan.
- Clarify that fiduciaries do not violate their duty of loyalty solely because they take participants' preferences into account when constructing a menu of investment options for participant-directed individual account plans.

The Final Rules are Undoubtedly Not the Last Word

After the new rules were adopted in November 2022, Republican legislators have introduced legislation to invalidate the final rules. Future administrations will likely have different views and make further changes regarding the ability of plan fiduciaries to consider ESG investments under ERISA and how they exercise plan shareholder rights.

Sources: Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights (Dec.1, 2022), available here; Congressional Republicans Propose Nixing DOL's ESG rule (Dec. 16, 2022), available here.

LITIGATION AND ENFORCEMENT ACTIONS

SEC Announces Enforcement Results for Fiscal Year 2022

The SEC announced its enforcement results for the fiscal year ended September 30, 2022, in which it recovered a record $6.436 billion in civil penalties, disgorgement and pre-judgment interest. The release cited enforcement goals of promoting market integrity, deterring future misconduct, increasing accountability and providing potential roadmaps for compliance. In furtherance of these goals, the SEC placed a greater emphasis on admissions of wrongdoing and imposed harsher penalties. The $4.194 billion in civil penalties reported in fiscal year 2022 is nearly triple the $1.456 billion in fiscal year 2021 and is more than the penalties the SEC imposed over the last three years combined.

The release cited the SEC's actions against 16 broker-dealers and one adviser for "widespread and longstanding failures to maintain and preserve work-related text message communications conducted on employees' personal devices." Each firm admitted to wrongful conduct, acknowledged recordkeeping violations and agreed to undertakings designed to remediate past failures and prevent future misconduct. The release noted that the firms paid $1.235 billion in penalties in the aggregate.

Recognizing Meaningful Cooperation; Whistleblower Tips

The release emphasized that the SEC takes cooperation into account when individuals and firms cooperate meaningfully and cited the integral role of the SEC's Office of the Whistleblower. This program received a record high number of whistleblower tips (more than 12,300) in fiscal 2022. The SEC issued approximately $229 million in 103 whistleblower awards, which was the second highest year in terms of dollar amounts and number of awards.

Other Enforcement Trends

The Enforcement Division placed importance on keeping up with industry trends, with a number of cases involving the crypto asset securities space, cybersecurity and ESG. In May 2022, the SEC announced the addition of 20 additional positions to the renamed "Crypto Assets and Cyber Unit" in the Division of Enforcement, and the year saw significant enforcement actions around unregistered crypto offerings and fraudulent crypto pyramid schemes. The Enforcement Division also reported a continued effort to curb market abuses and public finance abuse.

Sources: SEC Announces Enforcement Results for FY22, SEC Press Release 2022-206 (Nov. 15, 2022), available here; Securities and Exchange Commission, Addendum to Division of Enforcement Press Release Fiscal Year 2022 (Nov. 15, 2022), available here.

COMPLIANCE DATES FOR FINAL RULES

Final Rule	Compliance Dates
Amendments to Form N-PX and Say-on-Pay Vote Disclosure	Rule and form amendments effective for votes occurring on or after July 1, 2023, with the first filings subject to the amendments due August 31, 2024 for the 12-month period ended June 30, 2024
Shareholder Reports, Rule 30e-3 Amendments and Amended Advertising Rules	Rule and form amendments effective January 24, 2023, with a compliance date of July 24, 2024