

Investment Management Regulatory Update - October 2022

October 31, 2022 | Client Update | 4-minute read

In this issue we discuss, among other things, an SEC staff FAQ relating to investment adviser consideration of DEI factors.

Rules and regulations

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Rules and regulations

SEC proposes new oversight requirements for certain services outsourced by investment advisers

On October 26, 2022, the Securities and Exchange Commission (SEC) proposed new rule 206(4)-11 and rule amendments under the Investment Advisers Act of 1940 (Advisers Act) that prohibit SEC-registered investment advisers from outsourcing certain services or functions to service providers and third-party recordkeepers without meeting minimum due diligence and monitoring requirements. The new requirements are designed to protect investors and ensure that the outsourcing is consistent with investment advisers' obligations to their clients. Please see Davis Polk's [client update](#) for further information.

SEC adopts amendments to modernize fund shareholder reports, and fee and expense disclosures in investment company advertisements

On October 26, 2022, the SEC adopted new rule and form amendments that require mutual funds and exchange-traded funds to (i) transmit annual and semi-annual shareholder reports that highlight certain key information such as fund

expenses, performance and portfolio holdings, (ii) make available additional information that may be relevant to investors and financial professionals and (iii) provide enhanced expense-related disclosures in investment company advertisements. The new rule also excludes open-end registered investment companies from the scope of Rule 30e-3 under the Investment Company Act of 1940 so that open-end fund shareholders directly receive the enhanced shareholder reports. Please see Davis Polk's [client update](#) for further information.

Industry update

SEC staff FAQ relating to investment adviser consideration of DEI factors

On October 13, 2022, SEC staff issued an [FAQ](#) on an adviser's fiduciary duty when considering factors relating to diversity, equity, and inclusion (DEI) in the selection or recommendation of other investment advisers for its clients (the FAQ). According to a [statement](#) by Commissioner Caroline A. Crenshaw and Commissioner Jaime Lizárraga (the Statement), the FAQ was issued in response to the 2021 Asset Management Advisory Committee's report and recommendations to the SEC on DEI matters (the Report), particularly the lack of gender and racial diversity in the asset management industry.

The question raised in the FAQ was whether, under its fiduciary duty, an investment adviser may consider DEI factors when recommending or selecting other investment advisers for its client, provided that the use of such factors is consistent with the client's objectives, the scope of the relationship, and the adviser's disclosures.

In short, the FAQ response was that an investment adviser may consider a variety of factors in making a selection or recommendation of other investment advisers for its clients, including DEI factors, so long as such factors are consistent with the client's objectives, the scope of the relationship, and the adviser's disclosures. According to the FAQ, an investment adviser must have a reasonable belief that the advice it provides is in the best interest of the client based on the client's objectives, which typically involves consideration of a variety of factors. Further, the FAQ noted that the adviser's fiduciary duty does not require the adviser to restrict its recommendation or selection to investment advisers with certain characteristics, such as a minimum length track record or amount of assets under management.

Commissioner Crenshaw's and Commissioner Lizárraga's Statement remarked on the FAQ and the Report. The Commissioners noted that the Report focused on the current state of DEI in the asset management industry, as well as on studying investor interest in DEI matters and investors' need for transparency. According to their statement, the Report highlighted notable statistics regarding inequities in the industry, such as the fact that "of the \$70 trillion in global financial assets under management, less than 1% were managed by minority- or women-owned firms." Additionally, the Report "found that information related to an asset manager's gender and racial diversity—in its workforce, leadership, ownership, boards, and business practices—was 'increasingly accepted as a material consideration in the selection of and/or retention of an investment advisory firm.'"

The Commissioners explained that the purpose of the Report was to shed "light on potential discrimination and barriers to women and minorities in the industry" and provide "transparency around diversity practices and data, which carry considerable weight with investors." Namely, the purpose of the Report was disclosure, not to mandate specific practices.

The Commissioners emphasized the importance of the Report and noted that it deserves "prompt consideration." They further emphasized that the SEC remains committed to considering actions that could provide transparency on DEI issues and matters important to investors.