

## Investment Management Regulatory Update - November 2022

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In this issue, we discuss, among other things, recently adopted rule amendments on proxy voting disclosures by registered funds, “say-on-pay” voting disclosures by institutional investment managers, and registered fund shareholder reports.

### Rules and regulations

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## Rules and Regulations

### SEC proposes amendments to liquidity risk management and required swing pricing for certain funds

The SEC’s newly proposed amendments would require updates to certain registered fund liquidity risk management programs and would require swing pricing for certain funds. The proposal is designed to ensure that registered funds maintain an appropriate balance of liquid investments, standardize their classification of liquid investments, mitigate the dilution of remaining shareholders’ interests following net purchases or net redemptions and file timely reports that detail their liquidity risk management. For further information, please see our [client update](#).

### SEC adopts rules to enhance proxy voting disclosure by investment funds and require disclosure of “say-on-pay” votes for institutional investment managers

The [amendments](#) to Form N-PX enhance the information investment funds report about their proxy votes. The amendments also require institutional investment managers to disclose how they voted on executive compensation, or

so-called “say-on-pay” matters.

On November 2, 2022, the Securities and Exchange Commission (SEC) adopted amendments to Form N-PX to enhance the information mutual funds, exchange-traded funds (ETFs), and other registered management investment companies (collectively, registered funds) currently report annually about their proxy votes. The SEC also adopted new Rule 14Ad-1 under the Securities Exchange Act of 1934, as amended (Exchange Act) and amendments to Form N-PX requiring institutional investment managers subject to Section 13(f) of the Exchange Act (managers) to report annually on Form N-PX how they voted proxies on executive compensation, or so-called “say-on-pay” matters.

The amendments will become effective July 1, 2024. Therefore, managers and registered funds will be required to file their first reports on the amended Form N-PX by August 31, 2024, with these reports covering the period of July 1, 2023 to June 30, 2024.

## **Say-on-pay vote disclosure for institutional investment managers**

New Rule 14Ad-1 under the Exchange Act requires institutional investment managers<sup>1</sup> subject to Section 13(f) of the Exchange Act<sup>2</sup> to report on Form N-PX each say-on-pay vote over which the manager exercised voting power. The new rule completes implementation of Section 951 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).<sup>3</sup>

The SEC also adopted the following three amendments to Form N-PX that permit joint reporting of say-on-pay votes by managers, or by managers and registered funds, to avoid duplicative reporting:

- An amendment permitting a single manager to report say-on-pay votes in cases where multiple managers exercise voting power;
- An amendment permitting a fund to report its say-on-pay votes on behalf of a manager exercising voting power over some or all of the fund’s securities; and
- An amendment permitting affiliates to file joint reports on Form N-PX notwithstanding that they do not exercise voting power over the same securities.

In all three cases, the nonreporting manager is required to file a “notice” or “combination” Form N-PX identifying each manager or fund reporting on its behalf. Further, where another manager or fund reports say-on-pay votes on a manager’s behalf, the report on Form N-PX that includes the manager’s votes is required to identify the manager on whose behalf the filing is made and separately identify the securities over which the nonreporting manager exercised voting power.

Managers that request confidential treatment of certain or all the positions reported on their Form 13F may request that such information also be treated as confidential on their Form N-PX. The SEC stated, however, that it believes that confidential treatment could be justified only in narrowly tailored circumstances and generally would not be merited solely in order to prevent proxy voting information from being made public.

## **Form N-PX amendments**

The amendments to Form N-PX will:

- Require registered funds, and managers with respect to say-on-pay votes, to tie the description of each proxy voting matter to the issuer’s form of proxy and to categorize each matter by type to help investors identify votes of interest and compare voting records;
- Require registered funds, managers with respect to say-on-pay votes, to disclose how their securities lending activity impacted their voting; and
- Prescribe how registered funds, and managers with respect to say-on-pay votes, organize their reports and require them to use a structured data language to make the reports easier to analyze.

Each of these amendments is described below.

## **Identification of proxy voting matters and categories**

Currently, registered funds often use different language to describe a particular proxy proposal and do not categorize their proxy votes by type. The lack of a standardized description for each proposal can make it difficult to compare how funds voted on a particular proposal. To address this, the SEC now requires registered funds, and managers with respect

to say-on-pay votes, to identify proxy voting matters reported on Form N-PX in the same order and using the same language as on the issuer's form of proxy. As modified from the proposed amendment, this requirement will only apply to proxy votes if a form of proxy, or a proxy card, in connection with a matter is subject to rule 14a-4 under the Exchange Act, which requires the form of proxy to identify each voting matter. Additionally, in cases where an SEC proxy card is not available, the amendments require that where abbreviations are used on the form, they must be used consistently, and the abbreviation must be either generally understood or used in the issuer's description of the voting matter.

The amendment also requires registered funds, and managers with respect to say-on-pay votes, to categorize each proxy voting matter reported on Form N-PX so that investors can focus on the topics they find important. The amendment differs from the proposal in that the proposed categorization has been modified to reduce the number of categories and eliminate the use of sub-categories so as to minimize confusion on how to categorize matters. The adopted standardized categories include:

- **Director elections** (as changed from the proposal, this category is limited to elections, and other board matters are now categorized as “corporate governance”);
- **Section 14A say-on-pay votes** (no change from the proposal);
- **Audit-related** (no change from the proposal);
- **Investment company matters** (no change from the proposal);
- **Shareholder rights and defenses** (no change from the proposal);
- **Extraordinary transactions** (no change from the proposal);
- **Capital structure** (as changed from the proposal, this category encompasses the proposed category, “security issuance”);
- **Compensation** (no change from the proposal);
- **Corporate governance** (as changed from the proposal, this category encompasses board matters other than director elections and the proposed category “meeting governance”);
- **Environment or climate** (no change from the proposal);
- **Human rights or human capital/workforce** (no change from the proposal);
- **Diversity, equity, and inclusion** (no change from the proposal);
- **Other social issues** (as changed from the proposal, this category encompasses the proposed category “political activities”); and
- **Other** (no change from the proposal).

When categorizing a particular voting matter, a registered fund or manager is required to select all categories applicable to the matter.

## Quantitative disclosures and securities lending

Investors currently do not have transparency into when funds do not cast votes because their securities are out on loan. To address this, the amendment requires registered funds, and managers with respect to say-on-pay votes, to disclose on Form N-PX (1) the number of shares that were voted (or, if not known, the number of shares that were instructed to be cast), (2) how those shares were voted (e.g., for or against proposal, or abstain) and (3) the number of shares that were loaned and not recalled for voting. The SEC noted that, in addition to providing context for understanding how securities lending activities affect registered fund and manager voting practices, the disclosure would allow an investor to understand the magnitude of split votes (i.e., when a registered fund or manager votes in multiple ways on the same matter).

## Structured data language and standardized reporting format

Reports on Form N-PX are currently required to be filed in HTML or ASCII. The SEC now requires registered funds, and managers with respect to say-on-pay votes, to file reports on Form N-PX in an eXtensible Markup Language (XML)-based structured data language, which would make it easier to analyze the data. The amendments standardize the order of the Form N-PX disclosure requirements and require a registered fund that offers multiple series of shares to provide Form N-PX disclosure separately by series.

## Website availability of fund proxy voting records

The SEC also adopted amendments to Forms N-1A, N-2, and N-3 that require registered funds to disclose that their proxy voting records are publicly available on (or through) their websites (if the registered fund has a website) and available upon request, free of charge in both cases. A registered fund can make its proxy voting record available through its website by providing a direct link on its website to its Form N-PX report on the SEC's Electronic Data Gathering, Analysis, and Retrieval (EDGAR) system.

## SEC adopts amendments for tailored shareholder reports and fee information in investment company advertisements

In a [release](#) dated October 26, 2022 (Adopting Release), the SEC unanimously adopted rule and form amendments proposed in August 2020<sup>4</sup> that require registered mutual funds and exchange-traded funds (ETFs, and together with mutual funds, open-end funds<sup>5</sup>) to transmit to shareholders concise and visually engaging annual and semi-annual shareholder reports that highlight key information, such as fund expenses, performance, and portfolio holdings, and to make available online and by request additional information that may be more relevant to investors and financial professionals who desire more in-depth information.

The final rules are based in part on advances in technology and feedback received by the SEC in a June 2018 survey on retail investor experiences with fund disclosures.<sup>6</sup> According to the Proposing Release and the Adopting Release, investors responding to the survey showed general preferences for more concise information, less technical writing, and increased use of tables, charts, and graphs in fund disclosures. Additionally, investors indicated that they are principally interested in information that will help them monitor their current investments, such as information regarding fund performance, fund holdings and fund expenses. Investors also indicated comfort with using the internet to access fund information and a preference for a layered disclosure framework.

To ensure that all open-end fund investors will experience the benefits of the new tailored shareholder reports, the SEC also adopted amendments to Rule 30e-3 under the Investment Company Act of 1940, as amended (1940 Act) to exclude open-end funds from the scope of the rule. Rule 30e-3 generally permits registered investment companies to satisfy shareholder report transmission requirements by making these reports and other materials available online and providing a notice of the reports' online availability, instead of directly providing the reports to shareholders.

In addition, the SEC adopted amendments to advertising rules for registered investment companies and business development companies (BDCs) that require fee and expense presentations in advertisements and sales literature to be consistent with relevant prospectus fee table presentations and be reasonably current. The amendments also address representations of fees and expenses that could be materially misleading.

### Contents and scope of shareholder reports

New Item 27A of Form N-1A provides that an open-end fund shareholder report may include only the following specifically permitted or required information (and information necessary to make the disclosures not misleading). However, a fund may omit inapplicable disclosure from a shareholder report, and modify a required legend or narrative information if the modified language contains comparable information. A fund may not incorporate by reference any information into its shareholder report.

Separate shareholder reports must be prepared for each series of a fund and, in a change from the Proposing Release, for each class of a multi-class fund.

*Cover page or beginning of shareholder report.* A fund must include on the cover page or at the beginning of its shareholder report:

- The fund's name and the class, if relevant.
- The exchange ticker symbol of the fund or the class, as applicable.
- If the fund is an ETF, the principal U.S. market or markets on which the fund's shares are traded.
- A statement identifying the document as an "annual shareholder report" or a "semi-annual shareholder report," as applicable.
- The following statement:

*This [annual or semi-annual] shareholder report contains important information about [the fund] for the period of [beginning date] to [end date]. You can find additional information about the fund at [website address]. You can also request this information by contacting us at [toll-free telephone number and, as applicable, email address].*

- If the shareholder report includes material fund changes, as described below, the following prominent statement, or similar clear and understandable statement, in bold-face type: “*This report describes changes to the fund that occurred during the reporting period.*”

**Fund expenses.** A fund must provide a table that shows (i) the fund or class name; (ii) expenses in dollars paid on a \$10,000 investment during the period; and (iii) expenses as a percent of an investor’s investment in the fund (i.e., expense ratio).<sup>7</sup>

**Management’s discussion of fund performance (optional for semi-annual shareholder reports).** A fund, other than a money market fund, must provide the following:

- A brief summary of the key factors that materially affected the fund’s performance during the reporting period, including the relevant market conditions and the investment strategies and techniques used by the fund’s investment adviser.<sup>8</sup>
- A line graph that shows the performance of a \$10,000 investment in the fund (with sales charges, as applicable) and in an appropriate broad-based securities market index<sup>9</sup> over a 10-year period (or the life of the fund, if shorter).
- A table that shows the average annual total returns of the fund (with and without sales charges, as applicable) and the appropriate broad-based securities market index for 1-, 5-, and 10-year periods (or the life of the fund, if shorter).
- A statement accompanying the line graph and table to the effect that (i) the fund’s past performance is not a good predictor of the fund’s future performance<sup>10</sup> and (ii) the line graph and table do not reflect the deduction of taxes that a shareholder would pay on fund distributions or redemption of fund shares.
- If the fund provides updated performance information on its website or through other widely accessible mechanisms, a statement directing shareholders to where they can find this information.
- If the fund has a policy or practice of maintaining a specified level of distributions to shareholders, it must disclose if it was unable to meet the specified level of distributions during the reporting period. The fund must also discuss the extent to which its distribution policy resulted in distributions of capital.
- If the fund is an ETF that does not provide premium and discount disclosure on its website in accordance with Rule 6c-11 under the 1940 Act, it must provide a table showing the number of days the market price of the fund shares was greater than the fund’s net asset value and the number of days it was less than the fund’s net asset value (i.e., premium or discount) for the most recently completed calendar year, and the most recently completed calendar quarters since that year (or the life of the fund, if shorter). A statement accompanying the table must provide that (i) shareholders may pay more than net asset value when they buy fund shares and receive less than net asset value when they sell fund shares, because shares are bought and sold at current market prices and (ii) the data presented represents past performance and cannot be used to predict future results.

**Fund statistics.** A fund must disclose the fund’s net assets, total number of portfolio holdings, the total advisory fees paid,<sup>11</sup> and, if the fund is not a money market fund, portfolio turnover rate as of the end of the reporting period.

Following these required statistics, a fund may provide additional statistics reasonably related to the fund’s investment strategy that the fund believes would help shareholders better understand the fund’s activities and operations during the reporting period (e.g., tracking error, maturity, duration, average credit quality, or yield). A fund may also briefly describe the significance or limitations of any disclosed statistics in a parenthetical or similar presentation (not in a footnote).

**Graphical representation of holdings.** A fund must provide one or more tables, charts, or graphs depicting the portfolio holdings of the fund, as of the end of the reporting period, by reasonably identifiable categories (e.g., type of security, industry sector, geographic regions, credit quality,<sup>12</sup> or maturity) showing the percentage of (i) net asset value, (ii) total investments, or (iii) total exposure (depicting long and short exposures to each category, to the extent applicable)<sup>13</sup> attributable to each category. A fund may also include, in a table or chart that appears near the graphical representation of holdings, a list of the fund’s 10 largest portfolio holdings, and the percentage of the fund’s (i) net asset value, (ii) total investments, or (iii) total exposure, as applicable, attributable to each such holding.

**Material fund changes (optional for semi-annual shareholder reports).** A fund must briefly describe any material change, with respect to any of the following items, that has occurred since the beginning of the reporting period.<sup>14</sup>

- The fund’s name;
- The fund’s investment objectives or goals;
- The fund’s annual operating expenses, shareholder fees, or maximum account fee, including the termination or introduction of an expense reimbursement or fee waiver arrangement;

- The fund's principal investment strategies;
- The principal risks of investing in the fund; and
- The fund's investment adviser(s), including sub-adviser(s).<sup>15</sup>

A fund may also disclose material changes it plans to make in connection with updating its prospectus for the current fiscal year (the Proposing Release would have required this disclosure), and other material changes that it would like to disclose to its shareholders or changes that may be helpful for investors to understand the fund's operations and/or performance over the reporting period.

A fund that discloses material changes must include a legend to the following effect: *"This is a summary of certain changes [and planned changes] to the fund since [date]. For more complete information, you may review the fund's next prospectus, which we expect to be available by [date] at [website address] or upon request at [toll-free telephone number and, as applicable, email address]."*

*Changes in and disagreements with accountants.* If during the fund's two most recent fiscal years or any subsequent interim period that the fund discloses on Form N-CSR, the fund's accountant resigned, declined to stand for re-election, or was dismissed, the fund must provide:

- A statement of whether the former accountant resigned, declined to stand for re-election, or was dismissed, and the date thereof; and
- A brief, plain English description of disagreement(s) with the former accountant during the fund's two most recent fiscal years and any subsequent interim period that the fund discloses on Form N-CSR.

*Availability of additional information.* A fund must provide a brief, plain English statement that certain additional fund information is available on the fund's website, including references to, as applicable, the fund's prospectus, financial information, holdings, and proxy voting information. A fund also may refer to other information available on its website if it reasonably believes that shareholders likely would view the information as important.

*Householding (optional).* A fund may include disclosure explaining how shareholders who have consented to receive a single shareholder report at a shared address may revoke this consent.

A shareholder report may be accompanied by other materials, but the shareholder report must be given greater prominence than other materials that accompany the shareholder report, with the exception of other shareholder reports, summary prospectuses or statutory prospectuses, or notices of internet availability of proxy materials.

## Format and presentation of shareholder reports

Item 27A provides certain general instructions related to the format and presentation of shareholder reports, including that:

- The information in shareholder reports must appear in the order prescribed in Item 27A. In a shareholder report that appears on a website or is otherwise provided electronically, the information must be organized in a manner that gives each item similar prominence as that provided by the order prescribed in Item 27A.
- Shareholder report disclosure must be in plain English.
- Funds are encouraged to use, as appropriate, question-and-answer formats, charts, graphs, tables, bullet lists, and other graphics or text features to respond to the required disclosures in shareholder reports.

## Electronic shareholder reports

For a shareholder report that appears on a website or is otherwise provided electronically (electronic shareholder report), <sup>16</sup> Item 27A encourages funds to use online tools (for example, tools that populate discrete sets of information based on investor selections – e.g., class-specific information, performance information over different time horizons, or the dollar value used to illustrate the fund's expenses or to populate the performance line graph, as applicable). The default presentation, however, must use the value that the applicable Item 27A requirement prescribes. Funds also may include in electronic shareholder reports (i) a means of facilitating electronic access to video or audio messages, or other forms of information (e.g., hyperlink, website address, Quick Response Code (QR code), or other equivalent methods or technologies); (ii) mouse-over windows; (iii) pop-up boxes; (iv) chat functionality; (v) expense calculators; or (vi) other forms of electronic media, communications, or tools designed to enhance an investor's understanding of material in the shareholder report.

In electronic shareholder reports, funds must provide a means of facilitating access to any information that is referenced in the shareholder report if the information is available online, including, for example, hyperlinks to the fund's prospectus and financial statements. Funds must provide a link specific enough to lead investors directly to the particular information, rather than to the home page or a section of the fund's website other than on which the information is posted. The link may be to a central site with prominent links to the referenced information.

## **New Form N-CSR requirements**

Funds will continue to be required to file shareholder reports on Form N-CSR. In addition, amendments to Form N-CSR require funds to file on Form N-CSR the following information currently included in shareholder reports:

- Complete annual or semi-annual financial statements;
- Financial highlights;
- Disclosures required by Item 304 of Regulation S-K regarding changes in and disagreements with accountants;<sup>17</sup>
- Information about matters submitted for a shareholder vote;
- Aggregate remuneration paid to directors, officers, and certain affiliated persons (unless disclosed as part of the financial statements); and
- Statement regarding the basis for the board's approval of the fund's investment advisory contract.

## **Website availability requirements**

Amendments to Rule 30e-1 under the 1940 Act require that the information newly required to be filed on Form N-CSR must also be made available on a website specified in a fund's shareholder report (other than the SEC's EDGAR website) from 60 days after the end of the fiscal half-year or fiscal year of the fund until 60 days after the end of the next fiscal half-year or fiscal year of the fund, respectively. A fund may satisfy this requirement by posting its Form N-CSR on the specified website.

In addition, a fund (other than a money market fund) must make its complete portfolio holdings, as of the close of the fund's most recent first and third fiscal quarters, available on a website specified in the fund's shareholder report from 60 days after the end of the first and third fiscal quarters of the fund until 60 days after the end of the next first and third fiscal quarters of the fund, respectively (i.e., for a full fiscal year).

The website materials may either be separately available for each series of a fund, or the materials may be grouped by the types of materials and/or by series, so long as the grouped information (i) is presented in a format designed to communicate the information effectively; (ii) clearly distinguishes the different types of materials and/or each series (as applicable); and (iii) provides a means of easily locating the relevant information (including, for example, a table of contents that includes hyperlinks to the specific materials and series). The information must be presented on the website in a format that is convenient for both reading online and printing on paper, and persons accessing the materials must be able to permanently retain, free of charge, an electronic version of such materials in such format.

Amended Rule 30e-1 includes a safe harbor providing that a fund shall have satisfied its obligations to transmit shareholder reports even if it did not meet the website availability requirements for a temporary period of time. In order to rely on this safe harbor, a fund must (i) have reasonable procedures in place to help ensure that the required materials appear online in the required manner and (ii) take prompt action to correct noncompliance with the website availability requirements.

## **Delivery upon request requirements**

Amendments to Rule 30e-1 also require a fund (or a financial intermediary through which shares of the fund may be purchased or sold) to send, at no cost to the requestor and by U.S. first class mail or other reasonably prompt means, a paper copy of any of the materials made available on the website, to any person requesting such a copy within three business days after receiving a request for a paper copy.

In addition, a fund (or a financial intermediary through which shares of the fund may be purchased or sold) must send, at no cost to the requestor, and by email or other reasonably prompt means, an electronic copy of any of the materials made available on the website, to any person requesting such a copy within three business days after receiving a request for an electronic copy.

## **Items removed from shareholder reports and not filed on Form N-CSR**

The final rules will not require the following currently required shareholder report items to appear in funds' shareholder reports or to be filed on Form N-CSR:

- Management information and statement regarding availability of additional information about fund directors;<sup>18</sup> and
- Statement regarding the operation and effectiveness of a fund's liquidity risk management program (LRMP).<sup>19</sup>

### **Amendment to scope of Rule 30e-3**

Current Rule 30e-3 generally permits investment companies to satisfy shareholder report transmission requirements by making the reports and other materials available online and providing a notice of that availability to shareholders, instead of directly mailing the reports to shareholders. To ensure that all open-end fund investors will experience the anticipated benefits of the new tailored shareholder reports, the SEC amended the scope of Rule 30e-3 to exclude open-end funds, which instead must transmit shareholder reports to shareholders. Funds will continue to be permitted to transmit shareholder reports electronically to shareholders that opt into electronic delivery.

### **Prospectuses and SAIs transmitted under Rule 30e-1(d)**

The SEC also rescinded Rule 30e-1(d), which permits a fund to transmit a copy of its prospectus or SAI in place of its shareholder report, if either or both of the prospectus or SAI includes all of the information that would otherwise be required to be contained in the shareholder report. The Adopting Release states that the SEC believes that the "consolidation of a fund's prospectus, SAI, and shareholder report disclosures into a single document is inconsistent with the layered disclosure framework" and understands that "funds rarely rely on this rule provision in practice."

### **Inline XBRL data tagging**

Funds will be required to tag the shareholder report contents in Form N-CSR filings in Inline eXtensible Business Reporting Language (Inline XBRL) to make shareholder report disclosure more readily available and easily accessible for aggregation, comparison, filtering, and other analysis.

### **Investment company advertising rule amendments**

The final rules include the following amendments to investment company advertising rules,<sup>20</sup> which will apply to all registered investment companies, including mutual funds, ETFs, registered closed-end funds and BDCs.

*Standardized fee and expense figures.* An investment company advertisement that provides fee or expense figures must include the following:

- The maximum amount of any sales load, or any other nonrecurring fee, and the total annual expenses without any fee waiver or expense reimbursement arrangement, based on the methods of computation prescribed by the investment company's registration statement form, and presented at least as prominently as any other fee or expense figure included in the advertisement.
- The expected termination date of a fee waiver or expense reimbursement arrangement, if the advertisement provides total annual expenses net of fee waiver or expense reimbursement arrangement amounts.

*Timeliness of fee and expense information.* Fee and expense information contained in an investment company advertisement must be as of the date of the investment company's most recent prospectus or, if the investment company no longer has an effective registration statement, as of the date of its most recent annual shareholder report. However, investment companies are permitted to provide more current information if available.

*Materially misleading statements about fees and expenses.* The final rules provide that representations about the fees or expenses associated with an investment in an investment company could be misleading because of statements or omissions made involving a material fact, including situations where portrayals of the fees and expenses associated with an investment in the investment company omit explanations, qualifications, limitations, or other statements necessary or appropriate to make the portrayals not misleading.

### **Technical amendments to Form N-1A**

The SEC amended the current SAI requirement to provide the age and length of service for a fund's officers and directors to allow funds to instead disclose for each officer and director the birth year and the year their service began. The SEC also adopted a similar instruction for the length of service for portfolio managers that must be disclosed in the prospectus

to permit a fund to disclose the year the portfolio manager's service began.

## Aspects of Proposing Release not adopted

The SEC did not adopt the following items from the Proposing Release:

- Proposed new Rule 498B, which would have permitted a fund to no longer send annual prospectus updates to existing investors if, among other things, the fund delivered a notice of material change within three business days after the effective date of a post-effective amendment filing or the filing date of a prospectus supplement with the change.
- Proposed amendments to funds' prospectus fee disclosure, which would have (i) replaced the existing fee table in the summary section of funds' statutory prospectuses with a simplified fee summary, and simplified the fee example that currently appears in funds' prospectuses; and (ii) permitted funds that invest 10% or less of their total assets in acquired funds to omit the Acquired Fund Fees and Expenses line from the fee table, and instead disclose this amount in a footnote.
- Proposed amendments to funds' prospectus risk disclosure, which would have (i) clarified that a "principal" risk is one that would place more than 10% of a fund's assets at risk and is reasonably likely to occur in the future; (ii) precluded disclosure of nonprincipal risks in the prospectus and (iii) required that principal risks be disclosed in order of importance.

## Compliance dates

The final rules will become effective 60 days after publication in the Federal Register. The compliance date for the final rules is 18 months after the effective date, except that (i) the amendments to the investment company advertising rules regarding materially misleading statements about fees and expenses and (ii) the technical amendments to Form N-1A, will each apply on the effective date.

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

On October 26, 2022, the SEC [proposed](#) new rule 206(4)-11 and rule amendments under the Investment Advisers Act of 1940, as amended (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.

## Background

In its proposing release, the SEC noted that the complexity and variety of investment opportunities and investor demands have evolved greatly since the Advisers Act was adopted. The simultaneous demand for cost-efficiency has led many advisers to outsource certain functions to third-party service providers. The types of outsourced functions range from those that support an investment adviser's core advisory services and processes, such as portfolio management, trading and risk management and robo-advisory services, to those related to middle- and back-office functions, such as settlement services or valuation services. According to the proposing release, while strategic outsourcing could increase access to specializations, reducing hiring burdens on investment advisers, and reduce risks related to advisers offering functions they are not equipped to perform, there is risk that clients could be significantly harmed if the service providers to whom such functions are outsourced are not properly monitored and managed. The SEC noted that outsourcing has the potential to defraud, mislead or deceive clients, and could have a material negative impact on clients, for example with inaccurate pricing and performance information on which clients may rely to make decisions regarding hiring or retaining investment advisers. The SEC also noted that certain conflicts of interest may exist for service providers, such as if an index provider holds an investment that it adds to its widely followed index. The SEC takes the position, therefore, that it would be deceptive sales practice and contrary to public interest were investment advisers to outsource key functions without taking appropriate steps to ensure that the clients will have the same protections investment advisers owe them under their fiduciary duties.

## Scope and application of the proposed rule and amendments

The proposed rule would apply to SEC-registered advisers that seek to outsource recordkeeping or functions (covered functions) that (1) are 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 the adviser's ability to provide investment advisory services. In the proposing release, the SEC noted that while the determination of what is a covered function would depend on the facts and circumstances, functions that are related to an adviser's investment decision-making process and portfolio management, such as providing investment guidelines and portfolio accounting services, as well as compliance functions, would generally meet the first element of the definition, though this would generally not include functions performed by marketers and solicitors. The SEC then noted that outsourced functions that are reasonably likely to cause a material negative impact on the client if not performed or performed negligently could include those that could cause a material financial loss or a material disruption of the adviser's operations. Clerical, ministerial, utility, and general office functions or services would be explicitly excluded from the proposed rule. The primary requirements for SEC-registered advisers introduced by the proposed rule and amendments include:

- Due diligence before retention of a service provider or third-party recordkeeper:  
Prior to retaining a service provider or third-party recordkeeper to perform a covered function or recordkeeping, an advisor must perform due diligence to reasonably determine that the intended outsourcing is appropriate, considering the following factors:
  - Nature and scope of the function;
  - Potential risk, risk mitigation, and risk management relating to performance of the function by the service provider or third-party recordkeeper;
  - Service provider's or third-party recordkeeper's competence, capacity, and resources necessary to perform the function;
  - Service provider's or third-party recordkeeper's material subcontracting arrangements related to the covered function;
  - Coordination with the service provider or third-party recordkeeper for federal securities law compliance; and
  - Orderly termination of the performance of the function.
- Periodic monitoring of the service provider's or third-party recordkeeper's performance
- Periodic reassessment of the selection of the service provider or third-party recordkeeper under the due diligence requirements of the rule
- Maintenance of books and records regarding service provider, and third-party recordkeeper, due diligence and monitoring performed
- Reporting on Form ADV census-type information relating to the service providers
- In the case of a third-party recordkeeper, obtaining reasonable assurances that the third-party recordkeeper will:
  - Adopt and implement internal processes and/or systems for making and/or keeping records that meet the requirements of the recordkeeping rule applicable to the books and records being maintained on behalf of the adviser;
  - Make and/or keep records that meet all of the requirements of the recordkeeping rule applicable to the adviser;
  - Provide access to electronic records; and
  - Ensure the continued availability of records if the third-party recordkeeper's relationship with the adviser or its operations cease.

Comments are due on or before December 27, 2022. The SEC proposes to require advisers registered or required to be registered to comply with the proposed rule starting ten months from the rule's effective date. If the proposed amendments are adopted, they would have a significant impact on the due diligence and monitoring obligations of SEC-registered advisers.

<sup>1</sup> The term "institutional investment manager" includes any person, other than a natural person, investing in or buying and selling securities for its own account, and any person exercising investment discretion with respect to the account of any other person.

<sup>2</sup> Section 13(f) of the Exchange Act requires an institutional investment manager to file a report with the SEC if it exercises investment discretion with respect to accounts holding certain equity securities (Section 13(f) securities) having an aggregate fair market value on the last trading day of any of the preceding 12 months of at least \$100 million. Rule 13f-1 under the Exchange Act requires that institutional investment managers file quarterly reports on Form 13F if the accounts over which they exercise investment discretion hold an aggregate of more than \$100 million in Section 13(f) securities.

<sup>3</sup> Section 951 of the Dodd-Frank Act added new Section 14A to the Exchange Act. This section generally requires public companies to hold nonbinding shareholder advisory votes to: (1) approve the compensation of its named executive officers; (2) determine the frequency of such votes, with the option of every 1, 2, or 3 years; and (3) approve “golden parachute” compensation in connection with a merger or acquisition (collectively, say-on-pay votes). Section 14A(d) of the Exchange Act requires that every manager report at least annually how it voted on say-on-pay votes, unless such vote is otherwise required to be reported publicly. In 2010, the SEC proposed rules to implement Section 14A(d) of the Exchange Act that would have required managers to file their record of say-on-pay votes with the SEC annually on Form N-PX, and would have amended Form N-PX to accommodate the new manager filings. The 2010 proposal was never finalized.

<sup>4</sup> See Tailored Shareholder Reports, Treatment of Annual Prospectus Updates for Existing Investors, and Improved Fee and Risk Disclosure for Mutual Funds and Exchange-Traded Funds; Fee Information in Investment Company Advertisements (Aug. 5, 2020) (Proposing Release), available at [www.sec.gov/rules/proposed/2020/33-10814.pdf](http://www.sec.gov/rules/proposed/2020/33-10814.pdf).

<sup>5</sup> Unless otherwise specified, this memorandum uses the term “fund” to refer to open-end funds.

<sup>6</sup> See Request for Comment on Fund Retail Investor Experience and Disclosure, Investment Company Act Release No. 33113 (June 5, 2018) (Investor Experience RFC). The comment letters on the Investor Experience RFC are available at [www.sec.gov/comments/s7-12-18/s71218.htm](http://www.sec.gov/comments/s7-12-18/s71218.htm).

<sup>7</sup> In a change from the Proposing Release, a fund will not be required to include in the expense example (i) information about the fund’s total return during the period or (ii) a footnote explaining that expense information does not reflect shareholder transaction costs associated with purchasing or selling fund shares.

<sup>8</sup> The instruction for this item encourages funds to use graphics or text features, such as bullet lists or tables, to present the key factors, and states that funds should not include a lengthy, generic, or overly broad discussion of the factors that generally affected market performance during the reporting period.

<sup>9</sup> For purposes of a fund’s shareholder reports and prospectuses, an “appropriate broad-based securities market index” must continue to be an index that is administered by an organization that is not an affiliated person of the fund, its investment adviser, or principal underwriter, unless the index is widely recognized and used. The final rules, however, revise the definition of “appropriate broad-based securities market index” to specify that the index must represent the overall applicable domestic or international equity or debt markets, as appropriate. A fund may also compare its performance to other more narrowly based indexes that reflect the market sectors in which the fund invests, additional broad-based indexes, or nonsecurities indexes (e.g., the Consumer Price Index), so long as the comparisons are not misleading.

<sup>10</sup> A fund must use text features to make this statement noticeable and prominent through, for example, graphics, larger font size, or different colors or font styles.

<sup>11</sup> The total advisory fees paid by the fund are only required to be disclosed in the annual shareholder report.

<sup>12</sup> If a fund depicts portfolio holdings according to credit quality, it should include a brief description of how the credit quality of the holdings were determined, and if credit ratings assigned by a credit rating agency are used, concisely explain how they were identified and selected.

<sup>13</sup> A fund that uses “total exposure” as a basis for representing its holdings may also include a “net exposure” presentation, as well as a brief explanation of these presentations.

<sup>14</sup> The Adopting Release states that the SEC is not defining a material change for this purpose as a change that would require a fund to file an amendment to its registration statement under Rule 485(a) under the Securities Act of 1933, as amended (Securities Act) because the SEC does not believe that linking this new disclosure requirement to that rule is necessary. The Adopting Release further states that factors funds may wish to consider in determining whether a change is material include “the nature of the change, whether it reflects a material change in the way the fund is currently being managed, whether it reflects a material change in the fund’s risk profile, which section(s) of the prospectus the change affects, and how likely the change would be to influence a shareholder’s decision to continue to invest in the fund.” In that regard, the Adopting Release notes that a change that affects the summary prospectus is more likely to rise to the level of a material change than one that would only affect the statutory prospectus.

<sup>15</sup> In a change from the Proposing Release, the list of material changes does not include a change to a fund’s portfolio manager.

<sup>16</sup> As discussed below, open-end funds will no longer be permitted to satisfy shareholder report transmission requirements by making their shareholder reports available online pursuant to Rule 30e-3. However, all open-end funds that rely on Rule 498 under the Securities Act to deliver summary prospectuses are required to make their shareholder reports available online.

<sup>17</sup> This requirement complements the requirement that funds must include a high-level summary of changes in and disagreements with accountants in their shareholder reports.

<sup>18</sup> A fund will continue to be required to provide identical information in its statement of additional information (SAI).

<sup>19</sup> While the Proposing Release would have required a fund to include a concise statement regarding its LRMP in its shareholder reports, the final rules do not include this requirement.

[20](#) Rules 482, 156 and 433 under the Securities Act and Rule 34b-1 under the 1940 Act.