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SEC Rules and Amendments

Liquidity Rule Amendments: Interval Funds to the Rescue?

On November 2, 2022, the Securities and Exchange Commission (SEC) voted to propose significant amendments to Rule 22e-4 under the Investment Company Act of 1940 (1940 Act), which governs mutual funds' liquidity risk management function (Liquidity Rule Amendments). As relevant to this discussion, the Liquidity Rule Amendments would effect the following changes:

- Require mutual funds to assume the sale of a prescribed stressed trade size equal to 10% of each portfolio investment (*i.e.*, a vertical slice) rather than the current approach, which allows mutual funds to assume the sale of a reasonably anticipated trade size in current market conditions.
- Remove the "less liquid" investment category and require mutual funds to treat all such investments as illiquid and subject to Rule 22e-4's 15% limit on illiquid investments.
- Expand the scope of the illiquid investment category by specifically including investments whose fair value is measured using unobservable inputs that are significant to the overall measurement (*i.e.*, "level 3" investments).
- Establish the following standards for determining whether a sale or disposition of an investment would significantly change the market value of such investment (Value Impact Standard) and thus potentially render the investment an "illiquid investment" under Rule 22-4:
  - For shares listed on a national securities exchange or a foreign exchange, any sale or disposition of more than 20% of the average daily trading volume of those shares, as measured over the preceding 20 business days.
  - For any other investment, any sale or disposition that the fund reasonably expects would result in a decrease in sale price of more than 1%.

Taken together, these aspects of the Liquidity Rule Amendments have the potential to significantly constrain some existing mutual fund portfolios and strategies. Presently, the "less liquid" investment category encompasses any investment that the fund reasonably expects to be able to sell or dispose of in current market conditions in seven calendar days or less without the sale or disposition significantly changing the market value of the investment, but where the sale or disposition is reasonably expected to settle in more than seven calendar days.

While this "less liquid" asset class largely consists of investments in bank loans, it also encompasses certain foreign investments (including those with settlement times that may extend temporarily due to, for example, holidays), certain debt securities and securities with seven-day demand features.[1] The Liquidity Rule Amendments would render all such assets illiquid investments subject to the 15% limit on illiquid investments.

Additionally, the Investment Company Institute (ICI) has pointed out that the proposed 10% size input and Value Impact Standard have the potential to significantly impact exchange-traded investments and stock funds generally. According to the ICI, "the 10% required trade size is a critical input that is likely to penalize many funds, especially large funds or even moderately sized funds that have more concentrated portfolios."

[1] See Eric J. Pan, president and CEO, Investment Company Institute, Comment Letter on Open-End Fund Liquidity Risk Management Programs and Swing Pricing; Form N-PORT Reporting (File No. S7-26-22), Feb. 14, 2023.

This penalization occurs though the transformation of, for example, highly liquid large-cap equity holdings into illiquid holdings through the application of 10% trade size assumption. The ICI concludes, "The 10% fixed vertical portfolio slice penalizes large funds and those with more concentrated portfolios, even though the portfolios of these funds may be highly liquid. Indeed, some funds would not be able to continue to operate in their current form despite holding the most liquid stocks in the US equity market and never having seen daily outflows approaching anything like 10%."

The potential impact of the Liquidity Rule Amendments is to make certain asset classes and investment strategies unworkable in an open-end mutual fund structure. This potential impact is not limited to niche investment strategies or certain categories of fixed-income investments, like bank loans. Rather, as the ICI comments demonstrate, the Liquidity Rule Amendments could also have a wide-ranging impact on the size, and thus the availability to retail investors, of stock mutual funds.

The potential impact is not theoretical. According to remarks made by members of the SEC staff at the ICI's annual Investment Management Conference in March 2023, SEC Chair Gary Gensler's thematic emphasis is on resiliency and transparency as key drivers of a functioning market, and the Liquidity Rule Amendments are part of this thematic approach.

The mutual fund industry should therefore prepare for the Liquidity Rule Amendments to be enacted in some form, though it is impossible to predict how any final amendments will differ from those that were proposed. If enacted as proposed, the Liquidity Rule Amendments have the potential to remove certain types of investment options for retail investors in a mutual fund format altogether (*e.g.*, bank loan funds), and to reduce the diversity and availability of many commonly sought mutual fund options, including some equity funds.

How Interval Funds Can Help

Closed-end funds might provide an answer for continued retail investor access to asset classes and strategies that the potential Liquidity Rule Amendments may drive out of mutual funds, and to additional pooled investment options in the event mutual funds pursuing certain investment strategies are forced to close their doors to new investors or shrink in size to remain in compliance with an amended Rule 22e-4.

Closed-end funds may offer a solution to provide retail investors exposure to asset classes and strategies that such investors either could not invest in as individuals or that would be impractical to pursue due to insufficient capital for meaningful diversification. Importantly, closed-end funds are not subject to Rule 22e-4 since they do not issue redeemable securities.

Closed-end funds come in several varieties.

- **The most common is the exchange-listed closed-end fund** that provides liquidity for investors through trading on an exchange, such as the New York Stock Exchange. An alternative closed-end fund structure, which has the potential to bridge the gap between the mutual fund and closed-end fund investor experience, is the "interval fund."
- **An "interval fund"** is a closed-end fund that is typically not exchange-listed and that is required, by "fundamental policy,"[2] to offer to repurchase 5%-25% of its shares, at net asset value, on a periodic basis (quarterly, semiannually or annually). Interval funds are governed by Rule 23c-3 under the 1940 Act.

While an interval fund is not subject to Rule 22e-4, it is subject to a more flexible liquidity requirement that, during the pendency of a repurchase offer, a percentage of the fund's assets equal to at least 100% of the repurchase offer amount must consist of assets that can be sold or disposed of in the ordinary course of business, at approximately the price at which the fund has valued the investment, within a period equal to the period between a repurchase request deadline and the repurchase payment deadline, or of assets that mature by the next repurchase payment deadline.

Note that the maximum time frame between a repurchase request deadline and a repurchase payment deadline is 21 days under Rule 23c-3.[3] Rule 23c-3 also contains a requirement that the fund's board adopt written procedures reasonably designed, taking into account current market conditions and the fund's investment objectives, to ensure that the fund's portfolio assets are sufficiently liquid so that the fund can comply with its fundamental repurchase policy and the liquidity requirements articulated above.

Taken together, these more flexible liquidity requirements could be more conducive to strategies deemed not liquid enough under an amended Rule 22e-4, but where investors continue to demand some reasonable amount of periodic liquidity at net asset value. For example, the SEC notes in the Liquidity Rule Amendments that bank loan settlements have increased to a maximum of T+23 and a median of T+15.[4] The liquidity requirements applicable to an interval fund are designed to accommodate situations such as these.

[2] A "fundamental policy" is an investment policy that can only be changed with a shareholder vote under the 1940 Act.

[3] The "repurchase pricing date" must be no later than 14 days after the "repurchase request deadline," and the "repurchase payment deadline" is seven days after the "repurchase pricing date." See 1940 Act Rule 23c-3(a).

[4] Open-End Fund Liquidity Risk Management Programs and Swing Pricing; Form N-PORT Reporting, 1940 Act Rel. No. 34746 (Nov. 2, 2022).

Additionally, an interval fund investing in listed equity would not be subject to potential Rule 22e-4 requirements that could render as "illiquid" listed securities that in fact have deep, liquid markets. Moreover, as a closed-end fund, an interval fund can take advantage of more flexible rules around the use of debt and preferred equity to meet the liquidity needs of common shareholders.

A variety of developments over the past several years have also made the interval fund investor experience not unlike the mutual fund investor experience. Interval funds routinely obtain SEC exemptive relief to sell multiple classes of shares to tap different distribution channels.[5] Recent improvements to the rules under the Securities Act governing closed-end fund offerings have also streamlined the offering process for interval funds.

Interval fund shares can also be sold and repurchased through the National Securities Clearing Corporation, just like mutual funds. Distribution partners in the industry continue to slot interval funds into retail distribution channels instead of in an alternatives space that may limit uptake though the application of heightened suitability requirements. As a result, the distribution-related fee and expense structure of interval funds is often similar to mutual funds.

Yet another benefit of interval funds for retail investors is the lack of any significant institutional shareholder activism that can limit the universe of potential strategies and/or make a fund unattractive or unavailable to retail investors. This is in contrast to listed closed-end funds, where institutional activists employ tactics to pressure closed-end funds to take action that benefits the activist but could harm long-term retail shareholders, or to seek to take over funds and repurpose them as highly speculative products and additional tools for activism.

Institutional activists in the closed-end fund space also tend to ignore interval funds because they do not offer the activist a spread between a market price and net asset value from which to profit.

Given the choice between losing investment options and diversity in personal portfolios through a reduction in mutual fund investment options, and slotting in an interval fund as a mutual fund alternative with reasonably appealing liquidity features, we suspect that many sponsors and investors will be eager to explore the latter option and the benefits it can offer.

[5] 1940 Act Rule 18f-3 only allows open-end mutual funds to issue multiple classes of shares; thus, closed-end funds must obtain exemptive relief to do so.

And with respect to existing mutual funds that may find themselves at odds with an amended Rule 22e-4, open-end to closed-end conversions have historically been rare. But the cost/benefit analysis from the considerations above, coupled with a continuing obligation to evaluate the appropriateness of the open-end structure for a fund under Rule 22e-4, may ultimately create the type of compelling case necessary for retail investors to trade liquidity for the continued availability of important and desired investment options.

Proposed Amendments to Custody Rule for Registered Investment Advisers

On February 15, 2023, the SEC proposed new rules and amendments to the "Custody Rule," Rule 206(4)-2 under the Investment Advisers Act of 1940 (the Proposed Rules). If adopted, the Proposed Rules would significantly expand the types of assets subject to Rule 206(4)-2 to capture any client assets, including "funds, securities or other positions held in the client's account."

The Proposed Rules would also:

- Redesignate Rule 206(4)-2 as the "Safeguarding Rule" instead of the "Custody Rule."
- Redefine custody to include advisers' discretionary trading authority.
- Subject banks, savings associations and foreign financial institutions to additional conditions before they are able to qualify as a "qualified custodian."
- Require that qualified custodians maintain "possession or control" of client assets.
- Require written agreements between advisers and qualified custodians to include provisions stating that qualified custodians will provide records to the SEC or independent public accounts upon request.
- Require advisers to obtain various assurances in writing from qualified custodians.

Notably, the Proposed Rules would also expand Rule 206(4)-2's current exception from the requirement to maintain certain privately offered securities with a qualified custodian to include "physical assets, including artwork, real estate, precious metals or physical commodities." However, the exception's availability would be limited to and subject to various restrictions.

For a full discussion of the Proposed Rules, see our March 24, 2023, client alert.

Proposed New Requirements To Address Cybersecurity Risks to the US Securities Markets

On March 15, 2023, the SEC proposed a broad set of new requirements for broker-dealers, clearing agencies, major security-based swap participants, the Municipal Securities Rulemaking Board, national securities associations, national securities exchanges, security-based swap data repositories, security-based swap dealers and transfer agents (collectively, Market Entities) to address their cybersecurity risks.

In an attendant statement, SEC Chair Gensler said, "The nature, scale, and impact of cybersecurity risks have grown significantly in recent decades. Investors, issuers, and market participants alike would benefit from knowing that these entities have in place protections fit for a digital age. This proposal would help promote every part of our mission, particularly regarding investor protection and orderly markets."

Summary

The proposed suite of requirements, designed to mitigate the impact of cybersecurity risks, includes:

- A proposed new cybersecurity rule under the Securities Exchange Act of 1934, 17 CFR 242.10 (Rule 10).
- Extending the reach of Regulation Systems Compliance and Integrity (Regulation SCI).
- Expanding Regulation S-P.

Rule 10 Requirements for Market Entities

Proposed Rule 10 would require Market Entities to establish, maintain and enforce written policies and procedures that are reasonably designed to address their cybersecurity risks.

Covered Entities

Some of the requirements of Rule 10 would apply to a subset of Market Entities referred to as "Covered Entities." The proposal defines Covered Entities to include:

- Registered brokers or dealers that (i) maintain custody of cash and securities for customers or other broker-dealers; (ii) introduce customer accounts to another broker or dealer that maintains cash and securities; (iii) have regulatory capital of at least $50 million; (iv) have total assets of at least $1 billion; (v) are market makers under the Exchange Act, the rules promulgated thereunder or the rules of a self-regulatory organization of which the broker or dealer is a member; or (vi) operate as an alternative trading system (ATS) or operate a National Market System Stock ATS.
- Clearing agencies.
- Registered major security-based swap participants.
- The Municipal Securities Rulemaking Board.
- Financial Industry Regulatory Authority (FINRA).
- National securities exchanges.
- Security-based swap data repositories.
- Registered security-based swap dealers.
- Transfer agents that are registered or required to be registered.

Annual Review and Assessment of Policies

Rule 10 would also require Market Entities to review and assess their written cybersecurity policies and procedures annually. At a minimum, Market Entities would be required to review and assess the design and effectiveness of their cybersecurity policies and procedures, including any modifications made in response to changes in cybersecurity risk. Covered Entities would be required to prepare a written report of the review, while those that are not Covered Entities would only need to prepare a written record of it.

Additional Requirements for Covered Entities

Policy and Procedural Aspects

The proposed rule mandates certain features and elements of a Covered Entity's cybersecurity policy and procedures, including:

- Robust controls to minimize user-related risks and prevent unauthorized access to information systems.
- Monitoring.
- Oversight of service providers.
- Periodic risk assessments.
- Methods and measures to detect, mitigate and recover from cybersecurity incidents.

Filing of Proposed Form SCIR

Covered Entities would be required to provide immediate written notice to the SEC in the event of a significant cybersecurity incident. For certain Covered Entities, the notice obligation would extend to reporting to other regulators. The proposed rule would require Covered Entities to file Part 1 of proposed Form SCIR (17 CFR.249.642) to provide the SEC with detailed incident information, including the response to and recovery from the incident and any subsequent information updates about it. The proposed form would require prompt filing — within 48 hours of a Covered Entity having a "reasonable basis to conclude" that a significant cybersecurity incident is underway or has occurred. Filings on Form SCIR would be made confidentially.

A two-pronged definition of "significant cybersecurity incident" is provided in the proposed rule. Under the proposed definition, a cybersecurity incident, or a group of related cybersecurity incidents, would be considered a significant cybersecurity incident if it:

- significantly disrupts or degrades the ability of the Market Entity to maintain critical operations; or
- leads to the unauthorized access or use of the information or information systems of the Market Entity, where the unauthorized access or use of such information or information systems results in or is reasonably likely to result in:
  - substantial harm to the Market Entity; or
  - substantial harm to a customer, counterparty, member, registrant or user of the Market Entity, or to any other person that interacts with the Market Entity.

Public Disclosures on Part II of Proposed Form SCIR

Covered Entities would be required to make two types of public disclosure through Part II of proposed Form SCIR, which would be required to be posted on an "easily accessible" portion of a Covered Entity's website.

- The first required public disclosure would be a plain English summary of the material cybersecurity risks to which the entity is subject, and how the entity assesses, prioritizes and mitigates those risks.
- The second required public disclosure would be a high-level summary of each significant cybersecurity incident that occurred during the current or previous calendar year.

Regulation SCI Amendments

The SEC proposed amendments to Regulation SCI that would broaden the universe of entities covered by the rule, reaching:

- Registered broker-dealers that exceed certain activity or asset thresholds.
- Registered security-based swap data repositories and clearing agencies exempted from registration.

Regulation SCI currently requires the maintenance of policies and procedures designed to ensure the operational capability of certain systems, promote the maintenance of fair and orderly markets and ensure that certain systems operate in compliance with the Exchange Act and entities' own rules and governing documents. It also requires notice to the SEC and taking corrective action in response to system issues. Additional requirements imposed by the proposed amendments to Regulation SCI would include:

- Maintenance of a written inventory of systems and their classifications.
- Minimum requirements that an SCI entity's Rule 1001(a) policies and procedures must contain, including a program for the prevention of unauthorized access to SCI systems.
- Increased frequency of penetration testing from every three years to annually.
- Notification to the SEC of any systems intrusion without delay.
- An expanded definition of systems intrusion, including any event that disrupts, or significantly degrades, the normal operation of an SCI system and attempted, unsuccessful but significant unauthorized system entries.
- More robust business continuity/disaster recovery plans.
- Oversight of third-party providers that provide functionality, support or service for SCI systems.
- A requirement that objective personnel assess the risks to SCI systems, internal control design and operating effectiveness, as well as third-party provider management risks and controls.
- Various documentation, disclosure and recordkeeping requirements.

In addition, the proposed amendments would clarify that following current industry standards operates as a safe harbor under the rule.

Regulation S-P Amendments

Regulation S-P, commonly known as the "Safeguards Rule," requires that covered institutions (brokers, dealers, investment companies and registered investment advisers) adopt written policies and procedures to protect customer information and records.

The proposed amendments would require covered institutions to create an incident response program reasonably designed to protect, mitigate and combat unauthorized access to or use of customer information. The proposed amendments do not include formal requirements for incident response programs in order to provide flexibility for institutions to tailor their programs to their individual facts and circumstances. Additionally, if a reasonable investigation suggested that customer information was or was reasonably likely to have been used or accessed, institutions would be required to notify individuals as soon as practicable, and within 30 days.

Amended Regulation S-P would also extend existing rules on the safeguarding and proper disposal of customer information to all "customer information," newly defined to include any record containing nonpublic personal information in any form about a customer of a financial institution, whether collected by a covered institution or received about customers of other financial institutions.

The proposed amendments would also extend the rule's incidence response, safeguarding and disposal requirements to transfer agents registered with the SEC or another regulatory agency.

Comments are due on these proposals 60 days after their publication in the Federal Register.

Reopened Comment Period for Proposed Cybersecurity Risk Management Rules and Amendments for Registered Investment Advisers and Funds

On March 15, 2023, the SEC reopened the comment period on proposed rules and amendments pertaining to cybersecurity risk management and related disclosure for registered investment advisers, registered investment companies and business development companies. Comments are due on May 22, 2023.

For additional discussion of cybersecurity risk management rules, see our article in the May 2022 issue of this newsletter.

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

On March 15, 2023, the SEC proposed amendments to Regulation S-P (the Proposal) that would require broker-dealers, transfer agents, investment companies and registered investment advisers (collectively, Covered Institutions) to notify individuals affected by certain data breaches. Covered Institutions would also need to adopt written policies and procedures to address such unauthorized access of customer information.

In an accompanying statement, SEC Chair Gensler said that although "Regulation S-P currently requires covered firms to notify customers about how they use their financial information, these firms have no requirement to notify customers about breaches." Accordingly, "under [the proposed amendments,] covered firms would be required to notify customers of breaches that might put their personal financial data at risk."

Background

In 2000, the SEC adopted Regulation S-P, which:

- Requires investment companies, registered investment advisers and broker-dealers to adopt written policies and procedures to protect customer information and records (the Safeguards Rule).
- Mandates proper disposal of consumer report information to guard against unauthorized access to such information (the Disposal Rule). The Disposal Rule applies to the same entities regulated by the Safeguards Rule, as well as to transfer agents registered with the SEC.

Given the increase in cybersecurity threats since the rule's adoption, the proposed amendments seek to update Regulation S-P by:

- **Adopting an incident response program.** Covered Institutions would need to adopt written policies to address unauthorized use of or access to customer information.
- **Notifying affected individuals.** Covered Institutions would have to notify individuals whose sensitive customer information was accessed without authorization as soon as practicable but no later than 30 days after the Covered Institution becomes aware of the data breach.
- **Documenting compliance.** Covered Institutions would need to maintain written records documenting compliance with the Safeguards Rule and the Disposal Rule.
- **Conforming Regulation S-P's annual privacy notice exception to the Gramm-Leach-Bliley Act (GLBA).** If certain statutory conditions are met, Covered Institutions would not be required to deliver an annual privacy notice, consistent with the GLBA.

Transfer Agents

Currently, the Safeguards Rule does not apply to transfer agents, and the Disposal Rule applies only to transfer agents registered with the SEC. The proposed amendments would extend both of those rules to transfer agents registered with the SEC or with any other appropriate regulatory agency.

Customer Information

The proposed amendments would expand the Safeguards Rule and Disposal Rule to cover "customer information," which, under the new definition in the Proposal, would mean any nonpublic information about a customer of a financial institution. The Safeguards Rule and Disposal Rule would apply to nonpublic information that a Covered Institution collects about its own customers, as well as such information it obtains from a third-party financial institution about that institution's customers.

Importantly, under Regulation S-P, the terms "customer" and "consumer" refer to an individual (*i.e.*, a natural person), so Covered Institutions are not required to comply with Regulation S-P with respect to an investor in a private fund that is not a natural person.

Requirements Under Proposed Rule

Adopting an Incident Response Program

The SEC is proposing to amend the Safeguards Rule to require that Covered Institutions develop and maintain written policies for an incident response program that would be reasonably designed to detect, respond to and recover from unauthorized access of customer information.

The incident response program would require written procedures on:

- Assessing the nature and scope of any incident involving unauthorized access to customer information.
- Taking appropriate measures to control the incident to prevent further unauthorized access.
- Notifying affected individuals (as discussed below).

Notifying Affected Individuals

As part of its incident response program, Covered Institutions would need to adopt policies on notifying affected customers in the event of a data breach. Notification must be given to each affected individual whose "sensitive customer information was, or is reasonably likely to have been, accessed or used without authorization."

Notification is required unless, after a reasonable investigation, the Covered Institution determines that the sensitive customer information has not been, and is not likely to be, used in a manner that would result in inconvenience or substantial harm. The proposed amendments define inconvenience or substantial harm as a "personal injury, or financial loss, expenditure of effort or loss of time that is more than trivial," including fraud, theft, harassment, impersonation, damaged reputation and impaired eligibility for credit. If a Covered Institution determines notice is not required, it must maintain a record of its investigation.

Covered Institutions must notify affected individuals as soon as practicable but no later than 30 days after the breach is discovered. Delays to the 30-day time period will be permitted only if the U.S. attorney general affirms in writing that providing notice to affected individuals poses a substantial risk to national security.

Notice of a data breach must be given to affected individuals in writing and must contain certain information:

- Details on the incident and the breached data.
- What has been done to protect the information from further unauthorized access or use.
- How those affected may respond to the breach themselves.

Because all 50 states require some form of customer notification of certain data breaches, many entities likely already have response programs in place, so the SEC staff generally anticipates that the economic benefits and costs of the proposed notification requirements will be limited.

The proposed amendment would also require that an incident response program include written procedures that address the security risks posed by service providers. These written procedures would require Covered Institutions to obligate their respective service providers, via a written contract between the two entities, to take appropriate steps to guard against unauthorized access to customer information.

Under the written contract, service providers must notify a Covered Institution of a breach that results in unauthorized access to a customer information system maintained by the service provider as soon as practicable but no later than 48 hours after it discovers the breach. Although a Covered Institution may delegate the notification requirement to such service provider, the Cover Institution would remain responsible for any failure to provide a required notice to affected individuals.

A service provider is defined as any person or entity that is a third party and receives, processes or otherwise is permitted to access customer information through its provision of services to a Covered Institution. This definition includes the affiliates of Covered Institutions if such affiliates are permitted to access customer information by providing its services.

Documenting Compliance

Consistent with existing books-and-records preservation requirements, the proposed amendments would require a Covered Institution to make and maintain written records documenting its compliance with the Safeguards Rule and Disposal Rule.

- **Registered investment advisers** would have to preserve records for at least five years, with the records in an appropriate office of the investment adviser for the first two years.
- **Investment companies** would have to preserve the records, apart from any policies and procedures, for at least six years, with the records in an easily accessible place for the first two years. Investment companies must preserve policies and procedures that are currently in effect or that were in effect any time within the past six years.
- **Broker-dealers and transfer agents** would have to preserve the records in an easily accessible place for at least three years and preserve any written documentation entered into with its service providers (as described above) for at least five years.

Conforming Regulation S-P's Annual Privacy Notice Exception to the GLBA

The GLBA requires financial institutions to provide customers with annual notices regarding their privacy policies. Similarly, Regulation S-P currently requires broker-dealers, investment companies and registered investment advisers to provide an annual privacy notice to its customers.

In 2015, Congress added an exception to the GLBA's annual privacy notice delivery requirements for financial institutions that meet certain requirements. The proposed amendments would provide a similar annual notice exception under Regulation S-P if a Covered Institution:

- Only shares nonpublic personal information to unaffiliated third parties in a manner that does not trigger the customer's statutory right to opt out.
- Has not changed its policies with regard to disclosing non-public personal information from those it most recently disclosed to the customer.

Takeaways

If the SEC's proposed amendments are adopted substantially as proposed, investment companies, registered investment advisers, broker-dealers and transfer agents will face the complex task of developing and implementing policies addressing unauthorized access of customer information as well as maintaining records documenting such compliance.

The scope of customer information includes not only information that a Covered Institution has on its own customers but also information that it obtains about customers of another financial institution. Moreover, the proposed amendments, if passed, would implement more rigorous notification standards pertaining to data breaches than many states currently require. Efforts to comply with the heightened regulations may result in substantial costs.

The comment period will remain open for 60 days after the publication of the Proposal in the Federal Register. The proposed compliance date is 12 months from the adoption of the proposed rule.

SEC Priorities

Commissioner Uyeda Delivers Speech on Concerns With Current SEC Regulatory Approach

On March 20, 2023, SEC Commissioner Mark Uyeda delivered a speech discussing his concerns with the current SEC regulatory approach and his views on significant regulatory topics, focusing on what he views as overlapping, complex regulatory proposals not grounded in the practical realities of modern U.S. markets.

Commissioner Uyeda's chief concern was the danger of regulation based on unrealistic expectations or theory. He noted multiple examples, including the recent open-end fund swing pricing proposal, through which he felt the SEC might do more harm than good in its regulatory approach to investment advisers.[6]

He also mentioned the recent proposals regarding amendments to Regulations S-P and SCI and cybersecurity risk management. Commissioner Uyeda made known his wariness of the volume and pace of recent regulation. He expressed concern that smaller firms, including minority- and women-owned firms, would likely be the most affected by the increasing pace of regulation, which could lead to industry and strategy consolidation and ultimately stagnation.

Commissioner Uyeda highlighted specific areas of regulatory change of particular concern.

Open-End Fund Liquidity

First, Commissioner Uyeda discussed the prevailing narrative that open-end funds engage in "liquidity transformation" by allowing investors to purchase or redeem shares daily while holding assets that are generally less liquid. He noted that according to some academics, financial organizations and foreign central banks, open-end funds' liquidity transformation may incentivize investors to rush to redeem in market downturns.

The prevailing narrative may not be entirely correct, Commissioner Uyeda posited. He contended that the academic studies supporting the prevailing view of liquidity transformation by open-end funds are not sound because they rely on a lack of data or incomplete data and suggested that the SEC should use more recently available data, such as the publicly available information provided by fund filings on Form N-PORT, to examine the liquidity transformation risk narrative.

He further suggested that the liquidity transformation narrative has been generally focused on European funds and applied to U.S. mutual funds without properly accounting for fundamental differences between European and U.S. regulatory regimes, distribution channels and types of investors.

Commissioner Uyeda also expressed skepticism of the common view that U.S. mutual funds present systemic risk that may be addressed by swing pricing and restrictive liquidity requirements.

[6] Open-End Fund Liquidity Risk Management Programs and Swing Pricing; Form N-PORT Reporting, Securities Act Release No. 11130 (Nov. 2, 2022). For more information, see our article in the February 2023 issue of this newsletter.

ESG

Commissioner Uyeda also expressed hesitance regarding the SEC's regulation of ESG investing strategies. He argued that the SEC's recent ESG proposals reflected a regulatory approach not grounded in reality. He provided as examples of ESG regulatory failure the European Union's sustainable finance regime, including the Corporate Sustainability Reporting Directive[7] and the Sustainable Finance Disclosure Regulation.[8] Commissioner Uyeda contended that both policies faced significant regulatory challenges in implementation and impose substantial economic burdens.

Commissioner Uyeda opined that the SEC should carefully consider the mistakes he said EU regulators made and the significant differences between European and U.S. markets in developing U.S. regulation of ESG investment strategies.

Fund Names

The Fund Names proposal was also mentioned.[9] The proposal would greatly widen the ambit of the Fund Names Rule to include names denoting investments with, or investments whose issuers have, "particular characteristics," the meaning of which is not defined in the proposal. Commissioner Uyeda noted estimated compliance costs of up to $5 billion, likely to be passed to investors — an astounding figure he suggested may not be worth the uncertain benefits to investors and burden on SEC resources of the proposed changes to the rule.

Practical Areas for Improvement

Commissioner Uyeda concluded by discussing his desires that the SEC not excessively burden firms through premature rulemaking and seek to alleviate regulatory pressure where feasible. Commissioner Uyeda cited the adoption of rule and form amendments to streamline reporting as a positive step. In closing, he voiced his desire for the SEC to deviate from its current regulatory approach and promote a regulatory regime based on real world evidence, public input and thoughtful analysis rather than proceeding immediately to rulemaking based on hypotheses.

Division of Investment Management Highlights Industry Trends

On March 20, 2023, SEC Division of Investment Management (Division) Director William Birdthistle delivered remarks to the ICI Investment Management Conference assessing three industry trends of pressing importance to the future of investment management regulation: technological advancements, demographic shifts and rapid industry growth.

Technology. Director Birdthistle discussed three recent SEC proposals designed to address technological risks: two regarding cybersecurity and one regarding investment adviser custody. (See above discussions.)

Demographics. He noted steps the SEC has taken to address changing demographics, specifically in view of an aging workforce that is expected to soon invest at a historically high rate.

- The SEC adopted rule and form amendments in October 2022 altering the requirements for annual and semiannual shareholder reports provided by mutual funds and exchange-traded funds. New reports must be shortened, highlight important information for retail shareholders and allow product comparison.[10]
- The Fund Names Rule would require more funds to adopt an 80% investment policy by extending the rule to any fund name containing terms that indicate the fund focuses in investments that have particular characteristics and would also limit temporary departures from a fund's 80% investment policy.[11]
- Director Birdthistle also discussed the SEC's awareness of demographic trends within the asset management industry. He noted that the SEC's Office of Minority and Women Inclusion (OMWI) invites regulated entities every two years to conduct and submit voluntary self-assessments of their diversity policies and practices. Although regulated entities may submit their own self-assessments, OMWI provides entities with a Diversity Assessment Report tool.[12] OMWI's 2022 Diversity Assessment Report revealed a response rate of only 9% of the entities invited to participate in the survey of diversity policy and practices in the industry; Director Birdthistle encouraged firms to consider submitting self-assessments to OMWI.

[7] Directive (EU) 2022/2464 of the European Parliament and the Council of 14 December 2022 amending Regulation (EU) No 537/2014, Directive 2004/109/EC, Directive 2006/43/EC and Directive 2013/34/EU, as regards corporate sustainability reporting.

[8] Regulation (EU) 2019/2088.

[9] Investment Company Names, Securities Act Release No. 11067 (May 25, 2022) (Fund Names). For more information, see our article in the August 2022 issue of this newsletter.

[10] *See* Final Rule: Tailored Shareholder Reports for Mutual Funds and Exchange-Traded Funds. For more information, see our article in the February 2023 issue of this newsletter.

[11] *See* Proposed Rule: Investment Company Names, Rel. No. IC-34593 (May 25, 2022). For more information, see our article in the August 2022 issue of this newsletter.

[12] *See* OMWI Diversity Assessment Report survey.

Industry growth. Director Birdthistle discussed the rapid growth in the market overall and in product types due to the rise of contribution retirement savings and online investing. In particular, he noted the increasing prevalence of third-party service providers such as bespoke index providers and investment subadvisers in response to increasingly complex client demands and competition. He noted that in October 2022, the SEC proposed new Rule 206(4)-11 under the Investment Advisers Act as well as related changes to Form ADV and advisers' record-keeping obligations.[13]

The proposed rule would require due diligence prior to hiring a third-party service provider and ongoing monitoring of third-party service providers. Director Birdthistle emphasized that, despite engaging service providers, investment advisers retain ultimate responsibility to their clients for providing advisory services.

[13] *See* Proposed Rule: Outsourcing by Investment Advisers, Rel. No. IA-6167 (Oct. 26, 2022). For more information, please see our November 22, 2022, client alert.

Takeaways

While Director Birdthistle's speech did not address the substance of many of the SEC's recent rulemaking proposals in the asset management space, or industry criticism thereof, his speech did provide some insight into what the Division views as unifying themes for what, at times, appears to be scattershot rulemaking proposals.

With these insights, the industry may be able to better frame its views in the public comment process for the SEC's rule proposals and offer more practical solutions and suggestions that address the underlying thematic elements driving the SEC's rulemaking agenda in the asset management space.