

KITCES IAR ETHICS CE DAY

Regulation of Investment Advisers: Looking Ahead to Changes to the Regulatory Landscape







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Presenter



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Agenda

- 01** Regulatory Landscape – Big Picture
- 02** SEC Regulation of Smaller Advisers
- 03** Open SEC Rulemakings
 - Safeguarding Client Assets (Custody)
 - Predictive Data Analytics – Conflicts in Technology
 - Oversight of Outsourcing – Vendor Management
 - Cybersecurity Risk Governance
 - Data Privacy (Regulation S-P) (*recently finalized*)
 - ESG Disclosure
 - Anti-Money Laundering Regulation
- 04** Litigation Landscape – Implications for Investment Advisers
- 05** Conclusion



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Regulatory Landscape – Big Picture



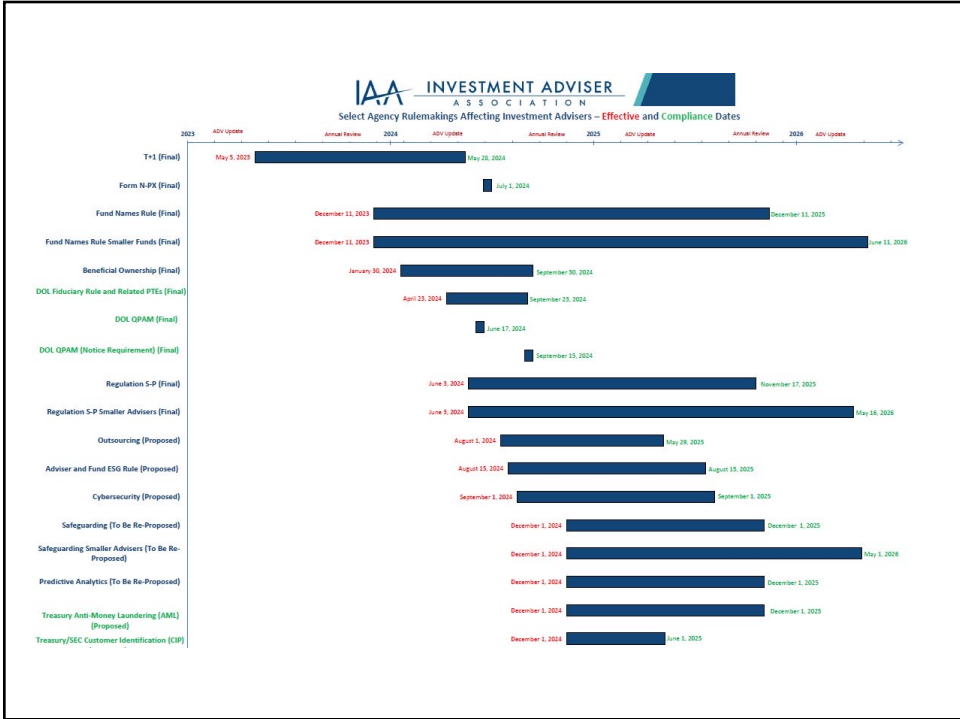
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Ambitious Rulemaking Agenda

- Rulemaking tsunami – unprecedented speed, scope & scale
- Changes to principles-based regulation of advisers
- Short periods for public feedback
- Short implementation timelines
- Cumulative impact and interconnectedness of new and existing regulation
- Impact of regulation on smaller advisers
- Not just the SEC – also Treasury, Dep't of Labor & FTC



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Cumulative Impact Of Regulation

- SEC should review its rulemaking agenda holistically
- Undertake assessment of cumulative costs, burdens, and other implications
- Address how these rules would affect smaller advisers and consider alternatives
- Seek public feedback on a comprehensive implementation timeline and staggered implementation dates for all proposals



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SEC Regulation Of Smaller Advisers



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SEC Regulation Of Smaller Advisers

- SEC required to consider impacts on smaller advisers in rulemaking; must consider alternatives
- SEC definition of smaller advisers: AUM of \$25 M or less – virtually no SEC advisers covered
- Legislation pending to ease burdens on small advisers – require SEC to update its definition
- IAA petition to SEC to update its definition



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Open SEC Rulemaking



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Custody/Safeguarding Proposal

- Proposed in February 2023. Will be repropoed
- Elements of current proposal:
 - Cover all assets, not just “funds and securities” – will include crypto, art, real estate, commodities, derivatives
 - Eliminate authorized trading exception and cover all discretionary authority to trade
 - Require advisers to enter into written contracts with clients’ custodians with specific terms and obtain reasonable assurances on a wide range of requirements
 - Privately offered securities subject to new obligations
 - Additional detailed recordkeeping requirements
 - New Form ADV reporting requirements



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Custody/Safeguarding Concerns

- By covering discretionary trading, expands concept of “custody” to include virtually all advisers
 - No surprise exam requirement for DVP transactions, but other new requirements would apply
 - No analysis that discretionary trading presents meaningful risks
- New requirements will apply to fee-billing custody as well
- Unrealistic requirements to enter into written agreements with custodians that custodians likely wouldn’t agree to
- Interposing advisers in client-custodian relationship
- Use of Advisers Act for backdoor regulation of custodians
- Significant burden on smaller advisers
- Transition period too short (one year for RIAs with >\$1 billion, 18 months for <\$1 billion)



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Predictive Data Analytics – Conflicts In Technology

- Proposed in August 2023
 - Specific requirements on how advisers manage conflicts arising from use of technology
- Breadth of proposal means it could capture everyone
 - Broad definition of “covered technology” – could include financial planning software, portfolio management software, excel spreadsheets
 - Broad and new definition of “conflict” – an interest of the adviser’s
 - Broad definition of “investor interaction” – any direct or indirect interaction with client or prospective client
- New concepts – adviser must “eliminate or neutralize” conflicts – different from existing fiduciary duty
- Wide opposition to proposal – unnecessary, undermines fiduciary duty – leading to decision to repropose



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Outsourcing Proposal

- New prescriptive minimum due diligence requirements before engaging service providers to perform “covered functions”
 - Includes affiliated service providers and service provider subcontractors
 - Includes service providers that are already regulated by federal financial regulator, e.g., broker-dealers, sub-advisers
- Specific monitoring requirements
- New recordkeeping requirements
- Oversight of third-party recordkeeping
- Form ADV disclosure of covered functions and service providers



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Outsourcing Proposal - Concerns

- If adopted as proposed, rule would result in sea change in vendor oversight processes
- Proposed rule unnecessary – advisers' fiduciary duty extends to outsourcing
- Concern that this is anti-fraud rule – huge costs for minor violations
 - Unclear what functions would be covered
- Unrealistic 10-month transition period proposed



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Outsourcing Proposal – Impacts On RIAs

- Required to jump through hoops to retain, or maintain, service providers
- Prohibited from outsourcing if all requirements aren't met
- Need to obtain reasonable assurances regarding compliance from vendors, advisers lack leverage
- Must disclose sensitive information on Form ADV
- Will incur significant cost and operational burden – especially for smaller firms and service providers
- May have difficulty retaining qualified personnel, especially if forced to in-source services



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Cybersecurity Proposal

- Report “significant” cyber incidents to SEC within 48 hours
- Have policies and procedures to address cyber risks at advisers and service providers, conduct annual reviews to assess effectiveness, document review
- Disclose cyber risk and incidents that occurred in past two years in Form ADV
- Maintain certain cyber-related books and records



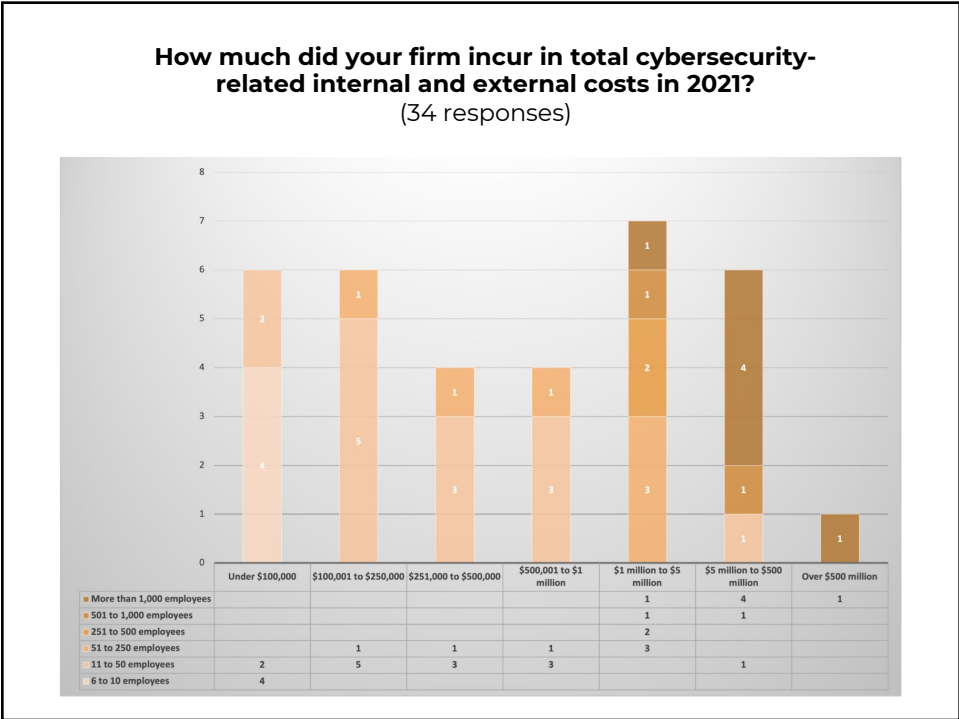
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Cybersecurity - Concerns

- Policies and procedures are important and already required under compliance program rule
- 48-hour reporting to SEC would impede advisers' efforts to respond
- Public disclosures could provide roadmap to threat actors
- IAA requested exclusion for smaller advisers from SEC reporting
- IAA Member survey shows SEC severely underestimates costs




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Data Privacy (Regulation S-P) – Final Rule

- Rare 5-0 unanimous SEC vote in May 2024, making important changes to proposal
- Reg S-P applies to RIAs, BDs, investment companies, transfer agents
- Key elements of final rule:
 - Require incident response programs in policies and procedures to enhance protection of customer information
 - Require breach notification to clients no later than 30 days if sensitive information was or is reasonably likely to have been accessed
 - Broaden scope of information covered by the rule
 - Broader recordkeeping requirements
 - Removes proposed written contract requirement
- Compliance date: 18 months for larger advisers, 24 months for smaller (<\$1.5 B AUM)



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ESG Disclosure For Advisers & Funds

- SEC proposal to require advisers and funds to make specific disclosures regarding their ESG practices
- Concerns
 - Advisers must clearly articulate investment strategies today so specific ESG rule not necessary
 - Proposal does not include materiality qualifier
 - Proposed disclosures could overemphasize ESG and be overwhelming and even misleading



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Anti-Money Laundering & Customer Identification Programs For Advisers

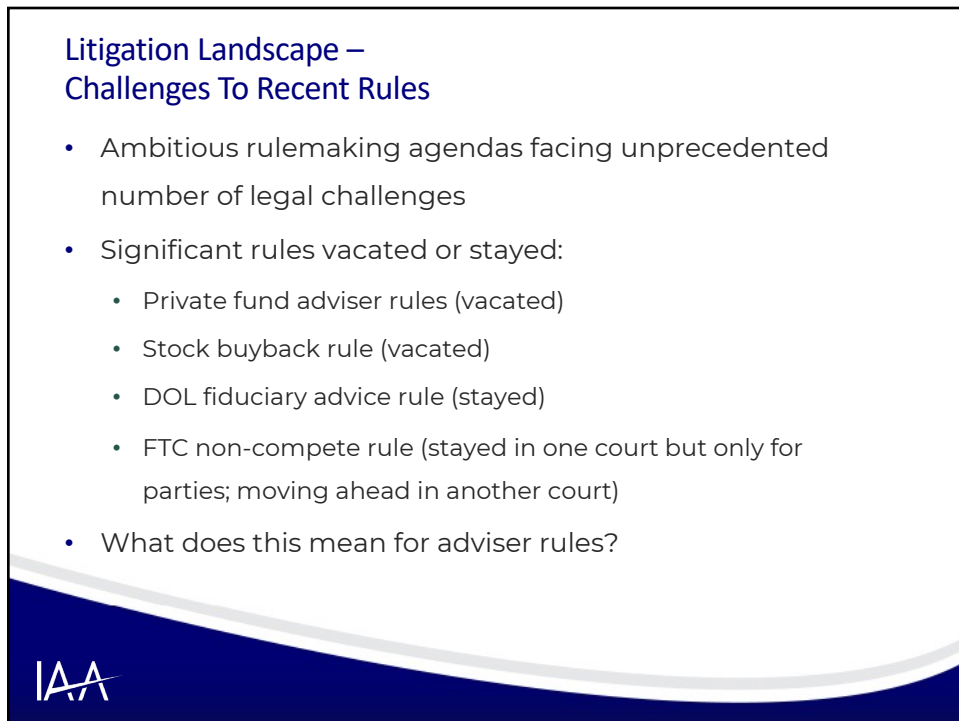
- AML proposal (Treasury, February 2024):
 - Direct AML requirements on virtually all advisers except:
 - Advisers to mutual funds
 - State-registered advisers
 - Must implement an AML program; cannot simply rely on custodian
 - Must file SARs (Suspicious Activity Reports)
 - New recordkeeping requirements
 - Final rule expected soon
- Proposed CIP (SEC & Treasury, May 2024)
 - Verification of client identity
 - Maintain records of information used for verification



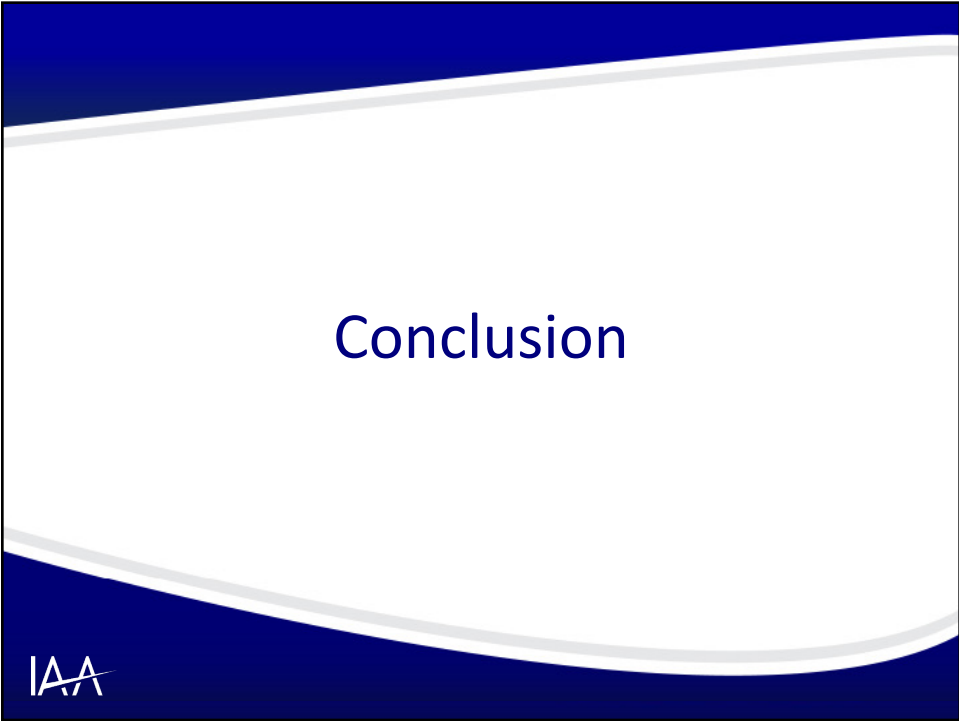
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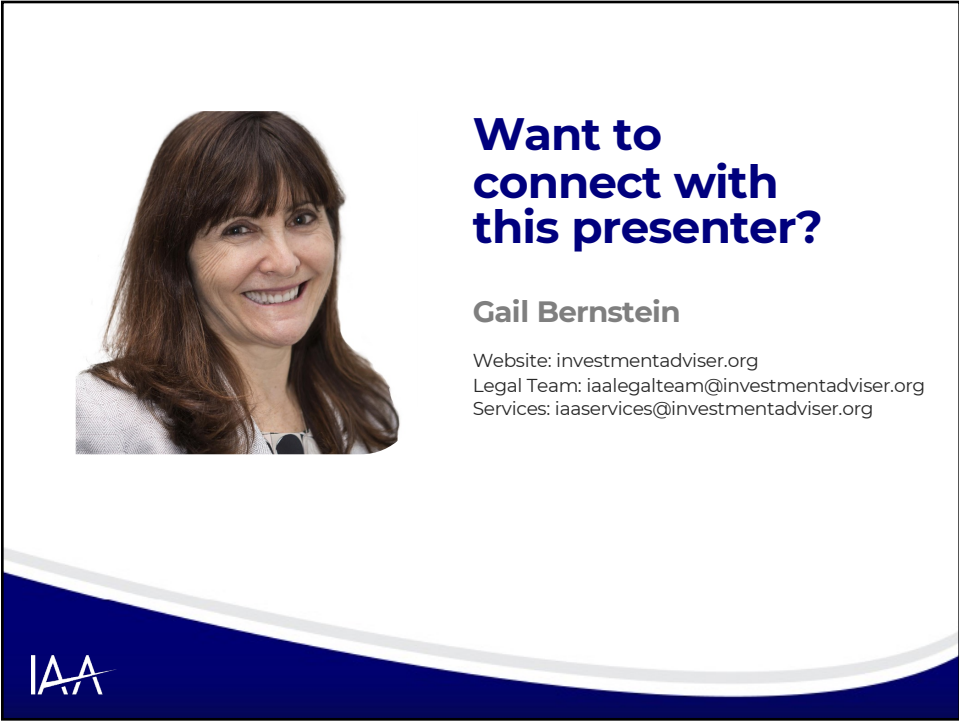
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