# SEC SOLICITS COMMENTS ON WHETHER INDEX PROVIDERS, MODEL PORTFOLIO PROVIDERS, AND PRICING SERVICES ARE INVESTMENT ADVISERS: SEEKING A PROBLEM FOR A "SOLUTION"

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**U.S. Asset Management and Investment Funds Alert**

## INTRODUCTION

On 15 June 2022, the Securities and Exchange Commission (SEC) issued a “Request for Comment on Certain Information Providers Acting as Investment Advisers” (Request).[1] The Request addresses three categories of what the SEC refers to as “information providers” or “providers:” *index providers; model portfolio providers;* and *pricing services.*[2] The SEC is seeking comment with respect to information providers “whose activities, in whole or in part, may cause them to meet the definition of 'investment adviser' under the Investment Advisers Act of 1940” (Advisers Act)[3] and whether these information providers meet the definition of being an “investment adviser” to an investment company under the Investment Company Act of 1940 (1940 Act).[4] Historically, information providers have not been subject to regulation under the Advisers Act due to the nature of their services and products. The Request suggests that the SEC is reconsidering information provider status under the Advisers Act. Comments are due on the later of (1) 16 August 2022, or (2) 30 days after the Request is published in the Federal Register.

As discussed further in this alert, Advisers Act regulation of information providers would potentially bring a range of new requirements and considerations to the provider industry – from Uniform Application for Investment Adviser Registration (Form ADV) filings and new disclosure obligations, to the adoption of compliance programs and the hiring of chief compliance officers (CCOs), to heightened responsibilities that come along with being considered a fiduciary. The SEC in its Request is giving the information provider industry and other interested parties the opportunity to voice views on the appropriateness of such a change. We expected that the industry will take up this invitation.

## CHANGING TIMES

The Request notes the role of information providers has grown in size and scope in the asset management industry in recent years and states that the information providers' operations “raise potential concerns about investor protection and market risk”, citing front-running trades and conflicts of interest concerns.[5] When discussing each type of provider, the SEC focuses on the amount of discretion each provider has in rendering their products and services.

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## INDEX PROVIDERS

Index providers generally create, maintain, operate, calculate, and publish financial and securities indices, and license them to third parties for use in managing investment products. The SEC observes that index providers have "significant discretion" in creating and maintaining financial indices, "in some cases without publicly disclosing their index methodologies or rules."[6] The SEC sees this discretion being exercised at index design, reconstitution, rebalancing, and in response to index component corporate events (*i.e.*, mergers, reorganizations, etc.). The Request further remarks on the "specialization" of indices, index "customization", and the "bespoke" nature of certain indices.[7] The SEC asserts that index providers are making active decisions with respect to their indices created for the purpose of licensing to sponsors of investment products, and concludes that the inclusion or exclusion of index components "drives" advisers' decision to buy or sell those securities for their clients.[8]

## MODEL PORTFOLIO PROVIDERS

Model portfolio providers include "broker-dealers, asset managers, third-party strategists, asset allocators, and advisers."[9] The Request observes that these providers design, rebalance over time, and can customize their models, which can be used on a discretionary or non-discretionary basis. The Request includes "direct indexing" in the model portfolio category.[10]

## PRICING SERVICES

Pricing services provide prices, valuations, and additional data about a particular investment. Pricing services are also called "valuation agents or providers of fairness opinions."[11] Pricing services provide pricing services when market quotations are not available or over-the-counter markets render incomplete information necessary for the pricing of a security. The SEC asserts, "pricing services may exercise significant discretion" as to valuation methodology, inputs, further value adjustments, and meeting user-raised challenges.[12] The SEC also notes that different pricing services may produce different values for the same securities and that the same service may also offer different pricing levels for the same security depending on methods and needs.[13]

The Request reflects a belief by the SEC that the discretionary aspects of provider products and services alone warrant the application of the Advisers Act regulatory regime to providers. Notably, the Release does not discuss any past or present complaints, abuses, frauds, investor losses, investor confusion, market manipulations, market disruptions, or other bad or malicious effects attributable to these information providers. The process initiated by the Request is designed to facilitate the SEC's consideration of whether, given the "national presence" that certain information providers are able to have, regulatory action by the SEC is necessary or appropriate.

Any Advisers Act information provider regulatory regime ultimately adopted should be expected to impose new and significant costs and burdens on providers, which may ultimately be passed on to customers and investors that rely on provider products and services. Among other things, a new SEC information provider regulatory regime may subject information providers to the same requirements and responsibilities as registered investment advisers, including:

- New fiduciary or fiduciary-like obligations to customers or investors or other end users;

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- SEC registration on, and annual renewal filings of, Form ADV and mandated document deliveries to customers or investors or other end users;
- Mandated contractual provisions governing customer relationships;
- CCO designations and the development and implementation of written compliance manuals and codes of ethics;
- Increased costs of compliance; and
- SEC routine and for-cause inspections.

In addition, the wider investment management and financial services industries may experience costs from SEC regulation of information providers. These costs may be, among other things, the passing through of new compliance expenses to investors, reduced competition in the industry, and declining innovation to meet investor needs.

## INFORMATION PROVIDERS AND FIDUCIARY DUTY

The SEC makes clear in the Request that it is considering whether providers have fiduciary obligations to those who use their services. Question 8 asks whether providers view themselves as having fiduciary obligations, their view of the scope of such obligations, whether they have a narrower view of such obligations than "a traditional client-facing adviser," and how providers address conflicts of interest in their business relationships.[14] Presently, providers have a commercial relationship with their customers defined by contract. The federal imposition of fiduciary obligation on a provider may create obligations owed directly to customers, licensees, and buyers, or indirectly to end users or third-party beneficiaries, such as fund shareholders or advisory clients. In this respect, Advisers Act regulation of providers would represent a fundamental change in nature of the business relationships of providers with their customers. Provider relationships would no longer be governed solely by their contracts but also by federal regulation which, among other things, would establish a fiduciary duty including duties of loyalty and care in all aspects of their operations.

Even if the SEC ultimately does not impose full investment adviser fiduciary duties on providers, it may still attempt to impose regulatory obligations relating to, among other things, suitability standards, conflicts of interest mandates or prohibitions, regulatory anti-fraud liability, recordkeeping standards, and required disclosure or document delivery (*i.e.*, a Form ADV brochure) to end users of their products and services. The SEC's potential fundamental reframing of a provider's relationship with its customer, licensee or buyer to be a fiduciary or fiduciary-like one is expected to generate a significant amount of comments on question 8 alone.

## PUBLISHER'S EXCLUSION TARGETED

The SEC states that historically many information providers have relied on the "publisher's exclusion" from registration as an investment adviser under Section 2(a)(11) of the Advisers Act,[15] and discusses the fact that information providers frequently rely on the "publishers exclusion" from registration provided in Advisers Act section 2(a)(11)(D). The Request describes the elements of the "publisher's exclusion" from registration under the Advisers Act section 2(a)(11)(D), which excludes from being an investment adviser the "publisher of any bona fide

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newspaper, news magazine or business or financial publication of general and regular circulation."[16] The Request describes the interpretation of the "publisher's exclusion" by the 1985 Supreme Court in the *Lowe* decision, but states that, given the passage of time and the development of new business models since 1985, the staff of the SEC is considering the extent to which information provider activities raise investment adviser status questions and whether the applicability of the "publishers' exclusion" to information provider activities should be reevaluated.[17] This part of the Request is expected to generate many comments.

## THE REQUESTS FOR COMMENT – A TOTAL EVALUATION OF INVESTMENT ADVISER STATUS

The specific questions of the Request demonstrate that the SEC is considering whether and to what extent that the information providers should register as investment advisers and be subject to all aspects of the Advisers Act.

The Request has two "General" questions concerning defining information providers, their risks and conflicts of interest and their numbers in the United States. Request questions 3 to 16 generally seek information about information providers under the Advisers Act, including whether the SEC should create an exemption for providers (question 15) and the economic benefits and costs of regulating providers as investment advisers (question 16). Questions 17 to 21 target index providers, question 22 model portfolio providers, and questions 23 and 24 pricing services. Questions 25 to 29 deal with Advisers Act registration issues.

Questions 30 to 32 address the applicability of the entirety of the Advisers Act to providers who register under the act, the impact on providers and investors, and whether any SEC regulatory regime for information providers ought to be aligned with the regime of the European Securities and Market Authority and its EU Benchmarks Regulation. Questions 33 and 34 solicit responses concerning Advisers Act reporting and disclosure obligations for providers.

Finally, the Request discusses 1940 Act issues presented by information providers, including the 1940 Act's separate definition of an investment adviser to a fund, under questions 35 to 40.

## POTENTIAL SIGNIFICANT INCREASE IN ADVISER REGULATION

Information providers as well as advisers, funds, and investors relying on information provider products and services all should be aware of the potential consequences, costs, and compliance repercussions of any rulemaking that may ultimately result from the Request. In addition to the consequences highlighted above, such regulation may also be expected to:

- Reduce investment product and advisory service offerings to investors if costs cannot be shifted to investors;
- Result in the closure of some funds or other investment products if the existing, and any replacement, provider refuses or is unable to satisfy the regulatory requirements;
- Impose barriers to entry to new potential information providers or cause existing information providers to consolidate with other providers or shut down entirely;

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- Reduce the sophistication and future innovation in investment strategies available to retail investors if financial index or model construction is required to be simplified in order to avoid regulation by the SEC as an investment adviser or otherwise; and
- Impose additional burdens on registered fund boards and product sponsors for the oversight of index providers, model providers, or pricing services who become subject to SEC regulation (including in the context of registered funds, subjecting information providers that are deemed to be investment advisers to the shareholder and board approval requirements of Section 15 of the 1940 Act).

## CONCLUSION

The Request is far reaching in scope concerning information providers. While the Request seeks comment on the costs and burdens associated with Advisers Act regulation of providers, it does not articulate any specific problems in the industry other than some vague SEC concerns and observation of discretionary activity by providers. The scope of the Request leads us to expect that the Request will generate a significant amount of public comment.

# FOOTNOTES

[1] SEC Release Nos. IA-6050; IC-34618 (File No. S7-18-22), which can be found at this link https://www.sec.gov/rules/other/2022/ia-6050.pdf.

[2] As an indication that the SEC may be considering widening the scope of its regulatory jurisdiction, the Request seeks comment on whether any other types of information provider should be regulated by the SEC other than the three types considered in the Request. *See* Request, at 15, (Question 2) (Are there "any other types of information providers whose activities, in whole or in part, may raise investment adviser status issues? If so, which providers, and why?").

[3] *Id.* at 1 (Summary).

[4] *Id*. at 28-31.

[5] *Id.* at 3 and 5.

[6] *Id.* at 4-5 and n. 6.

[7] *Id.* at 4 and 6.

[8] *Id.* at 6.

[9] *Id.* at 7. See id. at n. 13 ("This discussion focuses on third-party model portfolio providers that sell models to wealth managers that apply them to client portfolios . . . versus internal firm models. This discussion includes as third-party model portfolio providers those persons who make available their own portfolios so that others can copy or license those portfolios in exchange for compensation. Portfolios may be made available through the provider's online platform.")

[10] *Id.* at 8 and n. 15.

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[11] *Id.* at 9 and n. 19.

[12] *Id.* at 10.

[13] The Request discusses 1940 Act rule 2a-5's adoption, which recognized the role pricing services play in fair valuation determinations by fund boards while noting the risks and conflicts of pricing services. In particular, the Request states, “Staff have also observed compliance issues in connection with registrants' interactions with third-party pricing services, including the risks of misleading disclosure regarding whether those services provide “independent” values and the possibility of stale or otherwise inaccurate valuations.” This statement is solely based on an SEC Compliance Alert from July 2008 on deficiencies and weaknesses related to reliance on third-party pricing services for valuing high yield municipal bonds. *Id.* at 11 and n.23. *See* Compliance Alert, SEC Division of Examinations (July 2008), available at https://www.sec.gov/about/offices/ocie/complialert0708.htm

[14] *Id*. at 17.

[15] Under Section 2(a)(11) an investment adviser is defined to mean: “means any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities;…”

[16] *Id*. at 14. The Request also addresses the Supreme Court's interpretation of the publisher's exclusion where a qualifying publication: “(i) provides only impersonal advice; (ii) is 'bona fide,' meaning that it provides genuine and disinterested commentary; and (iii) is of general and regular circulation rather than issued from time to time in response to episodic market activity.” See Lowe v. SEC, 472 U.S. 181, 208-210 (1985).

[17] *Id*. at 15.

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