Considering the Impact of Rulemaking on Small Funds

Summary

Congress must ensure that the SEC and other rulemaking agencies carefully consider the disproportionate impact and costs of regulations on small funds* and analyze how the size and interconnectedness of the entire regulatory regime put an unequal burden on small fund firms.

Background

Rulemaking agencies are bound by Congressional statutes requiring them to conduct cost-benefit analyses for new rules. For instance, the Investment Company Act requires the SEC to consider "whether the [rulemaking] action will promote efficiency, competition, and capital formation." But agencies often spend inadequate time studying rulemaking impacts on small fund firms in particular. Incomplete analysis, a lack of depth, overreliance on qualitative (rather than quantitative) assessments, and other shortcomings have plagued numerous rulemakings that are now affecting market participants.

Additionally, regulators often estimate the costs of their new rules in a vacuum, meaning they don't fully analyze the aggregate impact of other outstanding proposals and the entire regulatory regime. In recent years, the volume of rules from the SEC and other federal agencies targeting the asset management industry has soared. These rules and their implementation dates have often collided with or stacked upon one another, creating operational burdens and skyrocketing compliance costs that are not experienced equally among market participants.

Why It Matters

Smaller fund firms do not have the same resources (including personnel, technology, systems, and money) as larger firms, making compliance with new requirements inherently more difficult. Further, they do not have the same economies of scale or negotiating power with third parties that are increasingly essential in meeting complex and data-dependent regulatory requirements.

Flaws in the rulemaking process exacerbate these problems and result in disproportionate harms to smaller funds. This, in turn, directly and adversely impacts their shareholders, who may pay higher costs, in percentage terms, than large fund investors. Compliance-related costs have pushed small firms to merge or close their doors, leading to less choice and competition in the marketplace.

Smaller firms fulfill important niches in the market, often offering specialized products and customized services to investors. Regulation is designed to protect investors, not extinguish their choice of products and providers.

Lip Service Doesn't Cut It

Several of the SEC's recent rulemakings have glossed over their lopsided effects on small fund firms. **Consider the SEC's 2023 *Names Rule* amendments, for instance:**

- At the proposal stage, the SEC acknowledged that the amendments could be more costly to small funds as a percentage of managed assets, adding that large funds benefit from economies of scale and could thus "allocate a smaller portion of existing resources" toward compliance.
- Nevertheless, the SEC didn't see fit to quantify the disproportionate costs to smaller funds but instead used industrywide cost averages.
- Despite concerns from commenters and inadequate analysis, the SEC finalized the amendments and concluded that it didn't expect the costs to be "meaningfully different for smaller versus larger funds." Again, the SEC provided no numbers to back that assessment.
- This implementation is proving to be very dependent on vendors and service providers, and the related additional costs are largely fixed—resulting in higher costs to small funds as a percentage of assets.

* The Investment Company Institute's small funds membership is generally composed of firms with up to $15 billion in assets under management.

Operational Headaches

The onslaught of agency rulemaking in recent years, along with its cumulative impact over decades, has nearly buried many small fund firms. What's more, a piecemeal approach from regulators has forced fund firms to untangle a growing web of interconnected regulations—an especially difficult challenge for smaller firms, which typically have fewer resources. This deluge of complex regulations poses serious risks to investor choice and market competition.

THE PILE KEEPS GROWING

Small fund firms' burdens from SEC rulemaking alone have multiplied over the past 15 years. The SEC initiated most of these rulemakings on its own (i.e., most were not Congressionally mandated).

- **2024:** Enhanced Form N-PORT monthly reporting for funds
- **2024:** Reg S-P (privacy) amendments for funds and advisers
- **2023:** Short position and activity reporting for advisers
- **2023:** Names rule amendments for funds
- **2023:** More money market fund rule amendments
- **2023:** Shortened securities trading settlement
- **2022:** Enhanced proxy voting reporting for funds
- **2022:** Tailored shareholder reports for funds
- **2020:** Marketing rule for advisers
- **2020:** Fair value rule for funds
- **2020:** Derivatives rule for funds
- **2019:** Form CRS summary for advisers
- **2016:** Liquidity-related requirements for funds
- **2016:** Form N-PORT monthly reporting for funds
- **2014:** More money market fund rule amendments
- **2013:** Identify theft red flags rules for funds and advisers
- **2010:** Money market fund rule amendments
- **2010:** Political contributions rule for advisers

The Bottom Line

Small firms have a hard time being heard by officials in Washington. We rely on our representatives in Congress to oversee federal agencies to ensure that their rules have a sound purpose; they credibly quantify both benefits and costs, proceeding only where the former outweighs the latter; and they recognize the entire regulatory regime and its cumulative burdens. By carefully considering the effects of rules on small funds, the SEC and other agencies can foster a fairer and more competitive market for the benefit of investors.

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