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Investment Management Alert

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Economic Growth, Regulatory Relief, and Consumer Protection Act: Impacts on Investment Companies

The Economic Growth, Regulatory Relief, and Consumer Protection Act (Consumer Protection Act), signed into law on May 24, 2018, includes certain provisions that are particularly relevant to investment companies, both registered and unregistered.

- **Registered Closed-End Funds:** The Consumer Protection Act directs the Securities and Exchange Commission (SEC) to propose and finalize rules to allow any closed-end fund that is registered as an investment company under the Investment Company Act of 1940 (1940 Act) and is listed on a national securities exchange (a Listed CEF) or that makes periodic repurchase offers pursuant to Rule 23c-3 of the 1940 Act (an Interval Rule CEF, and together with a Listed CEF, an Eligible CEF), to use the securities offering and proxy rules generally available to other issuers.
- **Venture Capital Funds:** The Consumer Protection Act amends Section 3(c)(1) of the 1940 Act by adding an exemption from the definition of "investment company" for any "qualifying venture capital fund."
- **Puerto Rico and U.S. Territories:** The Consumer Protection Act amends Section 6(a)(1) of the 1940 Act to require investment companies organized or otherwise created under the laws of Puerto Rico, the Virgin Islands and other possessions of the United States to register with the Securities and Exchange Commission (SEC), subject to certain exemptions.

Parity for Closed-End Funds Regarding Offering and Proxy Rules

Overview

While the Consumer Protection Act is principally aimed at easing certain restrictions in U.S. federal banking law applicable to regional and community banks, it also contains provisions that could result in significant offering reforms for certain closed-end funds. Section 509 of the Consumer Protection Act instructs the SEC to propose rules by May 24, 2019, and to finalize rules by May 24, 2020, that permit Eligible CEFs to "use the securities offering and proxy rules, subject to conditions the Commission determines appropriate, that are available to other issuers that are required to file reports under Section 13 or Section 15(d) of the Securities Exchange Act of 1934."

The SEC is required to "consider the availability of information to investors, including what disclosures constitute adequate information to be designated as a well-known

seasoned issuer." As a result, as discussed below in further detail, while certain of the offering reforms implemented pursuant to Section 509 may be extended to all Eligible CEFs, other offering reforms may apply only to closed-end funds that qualify as well-known seasoned issuers (WKSI). In addition, Section 509 appears to invite the SEC to tailor a definition of a closed-end fund well-known seasoned issuer (CEF WKSI) that may be more or less difficult to satisfy than the existing WKSI definition under the Securities Act of 1933 (Securities Act) for other issuers. The SEC could also seek to impose heightened periodic reporting requirements (such as requiring the filing of 8-Ks, 10-Qs and other Securities Exchange Act of 1934 (Exchange Act) reporting forms) on Eligible CEFs (including CEF WKSIs) that seek to rely on any liberalized securities offering and proxy rules. As of June 30, 2018, we estimate that approximately 16 percent of all U.S. closed-end funds could qualify under the existing WKSI definition (82 of 518 closed-end funds).

Section 509 is intended to effect substantially similar changes to those that Section 803 of the Small Business Credit Availability Act (SBCA) provides for business development companies (BDCs) (discussed at length in our April 9, 2018, *Skadden Insights*). In particular, the SBCA, signed into law on March 23, 2018, allows BDCs to rely on liberalized offering, proxy and communications rules previously available only to operating companies. In addition, Section 499A of the Financial CHOICE Act of 2017 (the CHOICE Act)[1] contemplates substantially similar changes for CEFs generally (*i.e.*, not limited to Eligible CEFs).

One notable difference between the Consumer Protection Act and the CHOICE Act is that the Consumer Protection Act applies only to Eligible CEFs; other CEFs will not be mandatory beneficiaries of these revisions. For example, unlisted CEFs that conduct periodic issuer tender offers pursuant to Rule 13e-4 of the Exchange Act are not covered under the Consumer Protection Act. The SEC in its rulemaking process could determine to extend the benefits of a streamlined registration and offering process to a broader universe of CEFs or to all CEFs. Alternatively, the SEC could seek to extend offering reforms that apply to operating companies generally only to a more narrow group of Eligible CEFs that would qualify as CEF WKSIs. We expect that, along with the criteria to qualify as a CEF WKSI, these could be key issues of discussion between the CEF industry and the SEC during the rulemaking process.

In addition, in contrast to the SBCA and the CHOICE ACT, the Consumer Protection Act does not direct the SEC to make specific changes to its regulations; rather, it imposes a broader principles-based mandate on the SEC that reserves for the SEC the authority to impose conditions that it determines to be appropriate to securities offering and proxy rules for CEFs. As such, any rules revised or adopted by the SEC pursuant to Section 509 may not necessarily provide exact parity of treatment with operating companies (or BDCs pursuant to the SBCA). On September 26, 2018, Dalia Blass, director of the SEC's Division of Investment Management, as part of her testimony on the SEC's Oversight of the Division of Investment Management before the U.S. House of Representatives Committee on Financial Services, Subcommittee on Capital Markets, Securities, and Investments, stated that the SEC staff is preparing recommendations for the SEC to propose rules in response to Congress' directive under Section 509.

Expanding Access to Capital for Closed-End Funds

Depending on the SEC's response, Congress' directive under Section 509 presents significant cost savings and regulatory relief opportunities for Eligible CEFs. If the SEC fully implements changes consistent with congressional intent, then certain Eligible CEFs would be permitted to qualify as CEF WKSIs and file automatically effective shelf registration statements. Further, certain Eligible CEFs would be permitted to (1) forward incorporate future Exchange Act filings by reference, thereby eliminating the need to amend shelf registration statements to include new financial statements, and (2) use definitive offering documents to update substantive disclosures. Finally, Eligible CEFs would be able to rely on numerous safe harbor rules related to communications with the public before, during and after an offering.

The following paragraphs describe certain changes to the securities offering and proxy rules that may occur if the SEC gives full effect to the liberalization of such rules, as contemplated by Section 509. It is difficult, however, to predict how the SEC will implement the statutory directive. If the SEC fails to complete the revisions to the securities offering and proxy rules within the specified time frames, Section 509 provides that any Eligible CEF would be deemed to be an "eligible issuer" under the final rule of the SEC titled "Securities Offering Reform."[2]

[1] The CHOICE Act was passed by the U.S. House of Representatives on June 8, 2017, and was referred to the U.S. Senate Committee on Banking, Housing and Urban Affairs. Hearings by the Senate Committee were held on July 13, 2017. It is unclear at this time what action the U.S. Senate will take with regard to the CHOICE Act in its current form.

[2] Release Nos. 33-8591, 34-52056, IC-26993, FR-75 (December 1, 2005). Under this scenario, it is not clear how the Consumer Protection Act's principles-based mandate would be implemented. For example, because CEFs would not meet the definition of WKSI under Securities Act rules, it is possible that none of the benefits that are conditioned on WKSI status would be extended to CEFs.

Shelf Registration Statements and Prospectus Delivery

WKSI Status to Qualifying Eligible CEFs. A WKSI under Securities Act rules is an issuer that is required to file Exchange Act reports with the SEC and meets the following requirements: (1) it is eligible to use Form S-3 or Form F-3; (2) it must, as of a date within 60 days of filing its shelf registration statement, either (a) have a worldwide market value of its outstanding voting and nonvoting common stock held by non-affiliates of at least $700 million or (b) have issued in the last three years at least $1 billion aggregate principal amount of nonconvertible securities, other than common equity, in registered primary offerings for cash; and (3) it is not an "ineligible issuer."[3] To be Form S-3 or Form F-3 eligible, an issuer must, among other things, be an Exchange Act reporting company for 12 months and have a $75 million common share public float.

When an issuer qualifies as a WKSI, it can register a securities offering under the Securities Act on a shelf registration statement that becomes effective automatically upon filing. This streamlined registration process provides flexibility for WKSIs to time securities sales to meet market conditions without waiting for the SEC staff to review and comment on a registration statement and declare it effective.

For a CEF WKSI, these benefits would significantly reduce the costs associated with establishing and maintaining shelf offering programs. As noted previously, Section 509 directs the SEC to consider the information available to investors, including what disclosures constitute adequate information to be designated as a WKSI. The SEC may tailor a definition of a "CEF WKSI" that differs from the definition of WKSI for other issuers and could, for example, impose new or different periodic reporting requirements on CEF WKSIs.

Closed-End Fund Shelf Offerings. If the SEC fully implements the statutory directive, the following changes, together with other corresponding changes discussed below regarding the use of definitive offering documents and incorporation by reference, if adopted, are likely to result in significant efficiencies by creating a streamlined process for many CEF shelf filings and would also eliminate the need for costly and time-consuming individual no-action relief to file automatically effective registration statement updates for certain Eligible CEFs (including CEF WKSIs), since such updates would no longer be required in a post-effective amendment.

Specifically, securities issued by an Eligible CEF (including a CEF WKSI) that would otherwise meet the eligibility requirements of Form S-3[4] would be considered securities permitted to be offered and sold on an immediate, continuous or delayed basis pursuant to Rule 415(a)(1)(x) of the Securities Act. Further, Eligible CEFs (including CEF WKSIs) permitted to file a shelf registration statement under Rule 415 of the Securities Act would not be required to file post-effective amendments to effectuate prospectus disclosure updates (such as for the inclusion of their most recent audited financial statements). The shelf registration statement, however, would be expected to continue to have a maximum lifespan of three years from the date of effectiveness.[5]

Prospectus Delivery. If the SEC gives full effect to the relaxation of the securities offering rules, Eligible CEFs (including CEF WKSIs) with an effective base prospectus would be permitted to file a prospectus supplement disclosing any substantive changes from or additions to a previously filed and effective base prospectus and access the capital markets immediately. This could be extremely important for Eligible CEFs (including CEF WKSIs) by facilitating their ability to quickly sell shares when they trade at or above net asset value per share, or their ability to sell preferred or debt securities quickly when favorable rates are available, which can significantly impact returns to common shareholders. Furthermore, a CEF WKSI would have the ability to file an automatically effective registration statement, immediately followed by a prospectus supplement, thereby accessing the capital markets in a single day without the delay caused by SEC review.

Additionally, CEFs are required to deliver a final prospectus to each purchaser by printing and mailing hard copies to investors. If the SEC gives full effect to Section 509's directive, Eligible CEFs (including CEF WKSIs) would be able to rely on certain rules under the Securities Act, which would significantly reduce the cost and burden associated with prospectus delivery.[6] These potential changes, combined with the SEC's recent adoption of e-delivery for investment company shareholder reports, could result in significant cost savings for the CEF industry.

[3] Rule 405 of the Securities Act defines an "ineligible issuer" as, among other things, an issuer that has not filed all required reports during the preceding 12 months (or for such shorter period that the issuer was required to file such reports); an issuer that has (or whose subsidiary has) been convicted of a felony or misdemeanor; or an issuer that has violated (or whose subsidiary has violated) the anti-fraud provisions of the federal securities laws.

[4] Similar to the prior discussion regarding WKSI status, the SEC could potentially establish CEF eligibility criteria that may be more or less difficult to satisfy than the existing eligibility requirements for Form S-3.

[5] As part of the Securities Offering Reform, the SEC amended Rule 415(a)(5) of the Securities Act to provide that most shelf registration statements on Form S-3 expire after three years.

[6] Under Rules 172 and 173 of the Securities Act, an Eligible CEF (including a CEF WKSI) would not need to print and mail hard copies of the final prospectus to investors if it timely files the final prospectus with the SEC, commonly referred to as "access equals delivery." Such CEFs would also be permitted to provide a notice of registration in lieu of sending the final prospectus.

Incorporation by Reference Into Registration Statements and Proxies

If the SEC fully implements the statutory directive, Eligible CEFs (including CEF WKSIs) would likely be able to incorporate by reference into their shelf registration statements current and future Exchange Act filings. This would eliminate the need for Eligible CEFs (including CEF WKSIs) to amend their offering documents in order to include new financial statements or new material information and, along with the changes discussed above, may significantly reduce the costs associated with keeping current a shelf offering document and quickly producing a prospectus supplement for an offering. Eligible CEFs (including CEF WKSIs) that meet the eligibility requirements of Form S-3[7] also would be able to incorporate by reference previously filed documents into their proxy statements, including, for example, financial statements and information required by Regulation S-X and Regulation S-K.

It is notable that CEF registration statements do not necessarily have required content that perfectly overlaps with the required content of CEF Exchange Act filings. Given Section 509's mandate for the SEC to consider the availability of information to investors in the required rulemaking, we would expect the SEC to consider the overall disclosure and reporting regime for Eligible CFFs (including CEF WKSIs) in order to allow Eligible CEFs (including CEF WKSIs) to take full advantage of a streamlined offering process, as contemplated by Section 509. In the absence of the SEC taking the lead on this topic as part of the implementing rulemaking, CEF industry participants would need to evaluate how to modify the usual scope of information contained in Exchange Act filings so as to, if desired, take full advantage of the streamlined offering process adopted pursuant to Section 509.

Safe Harbors for Communications During the Pre-Filing Period and During the Waiting Period

If the SEC gives full effect to the relaxation of securities offering rules, Eligible CEFs (including CEF WKSIs) would be able to rely on rules that relax restrictions on issuer communications with the public prior to filing a registration statement and that allow issuers to disseminate certain information about themselves and the offering including, but not limited to, general business or financial information, earnings releases, financial projections, statements about future operations, products or services, and statements about future economic performance, as well as assumptions underlying any of these topics.

Issuers are prohibited from offering to sell securities through the use of a prospectus or otherwise unless a registration statement has been filed with the SEC. Given the Securities Act's broad definition of "offer" and "prospectus," this prohibition captures numerous communication methods and mediums. While rules-based safe harbors and exceptions exist, they have been unavailable to CEFs. This has required CEFs to rely on historical positions of the SEC and its staff regarding ordinary business communications while "in registration" that formed the basis for certain of these rules-based safe harbors and exceptions. Although these historical positions have been available to issuers, including CEFs, the Consumer Protection Act seeks to provide Eligible CEFs (including CEF WKSIs) with the additional comfort, flexibility and certainty that other issuers enjoy with respect to ordinary business communications and advertising an offering while "in registration"; contemplates opening the availability of these rules-based safe harbors and exceptions to Eligible CEFs (including CEF WKSIs); and seeks to expand Eligible CEFs' (including CEF WKSIs') flexibility in the case of certain rules that do not have a historical analog in prior SEC and SEC staff positions, such as the use of free writing prospectuses.

In particular, CEF WKSIs would be able to use free writing prospectuses and engage in unrestricted oral and written offers before a registration statement is filed, subject to certain conditions. Additionally, Section 509 of the Consumer Protection Act specifically provides that nothing in Section 509, or in any rule amendments made pursuant to the requirements of Section 509, may be construed to prevent an Eligible CEF (including a CEF WKSI) from distributing sales material under Rule 482 of the Securities Act, which governs the requirements for advertisements and other sales materials with respect to the securities of CEFs. However, given the SEC's extensive regulatory history regarding the form and content of investment company advertising, it is likely that any rulemaking pursuant to Rule 509 would seek to reconcile the added flexibility for CEF offering communications with the principles that govern the SEC's views on investment company advertising. In addition, CEFs relying on any such expanded safe harbors for offering communications would need to consider the status of such communications under FINRA Rules applicable to broker-dealer communications with the public, to the extent relevant to that CEF's particular facts and circumstances.

[7] See fn. 4.

General Summary of Anticipated Effect of Streamlined Shelf Offering Provisions

These potential benefits for Eligible CEFs (including CEF WKSIs) would have the effect of significantly reducing the high cost and frequent delays involved in CEF shelf filings. If the SEC gives full effect to the relaxation of the securities offering rules, CEF WKSIs would be able to file automatically effective shelf registration statements and conduct immediate takedowns to access the securities markets. Eligible CEFs not qualifying as CEF WKSIs, but that would otherwise qualify to register securities on Form N-2 to be offered and sold on an immediate, continuous or delayed basis pursuant to Rule 415(a)(1)(x) (in accordance with standards currently set forth in Form S-3 or to be adopted for Eligible CEFs), would only be required to file a registration statement that must be declared effective, and thus subject to SEC staff review and comment, once every three years. If these changes are appropriately implemented, Eligible CEFs (including CEF WKSIs) should otherwise be able to keep their shelf offering documents current through a combination of forward-incorporation by reference and filing prospectus supplements for particular offerings. And — to further streamline the offering process — Eligible CEFs (including CEF WKSIs) would be able to rely on the "access equals delivery" model for final prospectuses, rather than the current requirement of needing to print and deliver final prospectuses (whether that delivery is a physical hard copy or an electronic copy by email). The "access equals delivery" model would similarly apply to initial public offerings of Eligible CEFs and significantly reduce the costs and burdens of prospectus delivery in such transactions.

Section 504: Qualifying Venture Capital Funds

The majority of private investment funds rely on two exemptions to avoid "investment company" status under the 1940 Act: Section 3(c)(1), which exempts funds with 100 or fewer beneficial owners, and Section 3(c)(7), which exempts funds that only sell their securities to qualified purchasers. Section 504 of the Consumer Protection Act expands the Section 3(c)(1) exemption to include any "qualifying venture capital fund" that is beneficially owned by no more than 250 people. A "qualifying venture capital fund" is a venture capital fund,[8] as defined in the rules under the Investment Advisers of 1940 (Advisers Act), that has no more than $10 million in aggregate capital contributions and uncalled committed capital.

This amendment to Section 3(c)(1) will provide more flexibility to smaller venture capital funds.[9]

Section 506: Puerto Rico and U.S. Territories

Section 506 of the Consumer Protection Act eliminates Section 6(a)(1) of the 1940 Act, which provided an exemption from 1940 Act registration for "[a]ny company organized or otherwise created under the laws of and having its principal office and place of business in Puerto Rico, the Virgin Islands, or any other possession of the United States." Such companies are now (unless a different exemption applies) subject to 1940 Act registration requirements. Section 506 provides a three-year safe harbor for companies that are exempt as of May 24, 2018, with the option for the SEC to extend the safe harbor for up to an additional three years if the SEC determines that a further extension is "necessary or appropriate in the public interest and for the protection of investors."

[8] Under Rule 203(l)-1 of the Advisers Act, a venture capital fund is defined as a small business investment company or a private fund that (i) represents to its investors and potential investors that it pursues a venture capital strategy; (ii) does not hold more than 20 percent of the fund's capital commitments in non-*qualifying investments* (other than short-term holdings); (iii) does not borrow or otherwise incur leverage, other than on a short-term borrowing basis (and not in excess of 15 percent of the fund's capital commitments); (iv) does not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances; and (v) is not registered under the 1940 Act and has not elected to be treated as a business development company. A "qualifying investment" consists of any equity security issued by a qualifying portfolio company that directly is acquired by a qualifying fund and certain equity securities exchanged for the directly acquired securities. A "qualifying portfolio company" is any company that (1) is not a reporting or foreign-traded company and does not have a control relationship with a reporting or foreign-traded company; (2) does not incur leverage in connection with the investment by the private fund and distribute the proceeds of any such borrowing to the private fund in exchange for the private fund investment; and (3) is not itself a fund (*i.e.*, is an operating company).

[9] While "qualifying venture capital funds" are now excluded from the definition of "investment company" under the 1940 Act, their investment advisers may still be subject to either federal registration and/or state registration requirements.

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