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Closed-End Fund Activism Update

As we noted in our last update in May 2022, activist closed-end fund investors continue to take large positions in closed-end funds and engage in disruptive activity that may be harmful to long-term retail closed-end fund shareholders. Since May, it has become even clearer that activists are seeking full takeovers of funds at least as frequently, if not more frequently, than they are seeking a close-to-net-asset-value (or even above-NAV) "liquidity event," their most common goal in the past.

This dynamic is quite obvious in light of current litigation involving closed-end funds and activists, as well as in ongoing proxy contests. This continues to be especially concerning when funds with less common strategies are targeted, because it can result in the loss of a desired investment option for retail long-term shareholders if the activist, after the takeover, modifies the fund's strategy to something significantly more risky, designed to complement their overall activism and arbitrage strategies.

Delaware Enacts Protections for Closed-End Fund Investors

On July 28, 2022, Delaware Governor John Carney signed into law amendments to the Delaware Statutory Trust Act (DSTA). These include the addition of new Subchapter III — Control Beneficial Interest Acquisitions (Control Share Statute). The new subchapter applies to all registered closed-end funds and business development companies (BDCs) that are organized as Delaware statutory trusts and have a class of equity securities listed on a national securities exchange. The Control Share Statute contains provisions comparable to existing control share statutes in other states, although it also contains a number of enhanced protections for registered closed-end funds and BDCs.

The Control Share Statute differs in some respects from existing state control share statutes by virtue of being tailored to the unique regulatory and corporate governance considerations applicable to registered closed-end funds and BDCs under the Investment Company Act of 1940 (1940 Act) and restores Delaware to a state of parity with Maryland as a jurisdiction for organizing registered closed-end funds and BDCs. Of particular note is that the Control Share Statute is automatically applicable to all listed registered closed-end funds and BDCs, without any action on the part of the fund's board of trustees. Such funds generally cannot opt out of the statute. These provisions are designed to address the unique 1940 Act considerations applicable to registered closed-end funds and BDCs in the control share context.

The Control Share Statute represents an important step forward for the application of control share statutes to registered closed-end funds and BDCs and the most thoughtful state legislation to date addressing the unique 1940 Act considerations applicable to registered closed-end funds and BDCs in the control share context. We discuss the Control Share Statute in detail in our August 1, 2022, client alert, "Delaware Enacts Protections for Closed-End Fund Investors."

Boards of trustees of listed registered closed-end funds and BDCs and sponsors should carefully review their particular facts and circumstances and the provisions of the Control Share Statute, and consider its impacts, and whether they warrant any present action.

SEC Proposals Update

SEC Floats ESG Rule Proposal

On May 25, 2022, by a vote of 3-1, the U.S. Securities and Exchange Commission (SEC) proposed a series of comprehensive rule amendments that seek to categorize types of environmental, social and governance (ESG) strategies and impose requirements on funds and investment advisers to furnish specific disclosures in fund prospectuses, annual reports and investment adviser brochures regarding the ESG strategies that they pursue. The rules would apply to registered investment advisers (RIAs), registered investment companies (RICs), BDCs and advisers exempt from registration (ERAs).

The proposed rules would create a framework for disclosures about a fund or investment adviser's ESG investment strategies. They would impose reporting requirements vis-à-vis both investors and client-facing disclosures, as well as reporting requirements for funds and investment advisers in regulatory reporting to the SEC. Additionally, the SEC is proposing an amendment to Form N-CEN which would require all index funds, irrespective of whether they track an ESG-related index, to report identifying information about the index they track. Finally, the proposal includes a requirement for funds to tag their ESG disclosures using Inline eXtensible Business Reporting Language (Inline XBRL) to furnish investors and other market participants with machine-readable data.

SEC Proposes Revisions to Investment Company Names Rule

On May 25, 2022, the SEC released proposed amendments to Rule 35d-1 (Names Rule) under section 35(d) of the 1940 Act, and changes to registered fund reporting requirements and registration forms. Comments on the proposal are due by August 16, 2022.

Summary of Current Names Rule

Under the current Names Rule, a fund[1] is permitted to include references to particular types of investments (*e.g.*, "stock fund" or "bond fund"), industries (*e.g.*, "utilities fund" or "health care fund"), tax characteristics (tax-exempt funds) or geographic regions (*e.g.*, "Japan fund" or "European fund") in the fund's name if it adopts a policy to invest at least 80% of the value of its assets in the type of investment suggested by its name, and invests in accordance with such policy "under normal circumstances." The current Names Rule does not apply to funds whose names suggest a particular investment strategy (*e.g.*, "growth or "value") or overall portfolio characteristics (*e.g.*, "balanced" or "global" or "international").

Under the current Names Rule, funds are permitted to define and disclose what constitutes "under normal circumstances" based on their individual, unique investment strategies. Further, the current Names Rule is tested only at the time of investment. Thus, a fund that is not in compliance with its 80% investment policy must make future investments in a manner that will bring the fund into compliance. There is no requirement that a fund rebalance its portfolio aside from this incremental requirement when it makes a decision to invest. Additionally, there are currently no express or implied limits to how long a fund may deviate from its 80% policy outside of normal circumstances.

As the original adopting release for the current Names Rule indicates, the SEC at the time acknowledged the importance of giving funds flexibility to, among other things, make decisions necessary to preserve capital, mitigate downside risk, or otherwise exercise discretion,

[1] As in the proposal, references to a "fund" in this summary includes registered investment companies and business development companies (BDCs).

and to permit managers to exercise decision-making that they believe, in good faith, to be in the best interest of shareholders when faced with "adverse market, economic, political or other conditions."[2]

Summary of Proposal

Welcome to the Names Club

The proposed changes would expand the range of funds subject to the Names Rule to include any funds whose name includes terms suggesting that it focuses on investments that have, or whose issuers have, particular characteristics (*e.g.*, a name with terms such as "growth" or "value," or terms indicating that the Fund's investment decisions incorporate one or more ESG factors, like "green" or "sustainable").

According to the SEC, the scope expansion to include investment strategies is necessary because a name referring to a strategy "can also connote an investment focus" and such "connotation is likely to be materially deceptive and misleading unless supported by an 80% investment policy." Other terms in fund names that have not historically been subject to the Names Rule, but would fall within the expanded scope, according to the SEC, include "global," "international," "income" or "intermediate term (or similar) bond."

While the SEC indicates that it does not intend to subject funds to an 80% investment policy requirement if a name merely suggests the "characteristics of the fund's overall portfolio," such as "long/short," "duration," "balanced" or "real return," combining terms related to such characteristics with other terms that connote an investment focus would result in application of the Names Rule — *e.g.*, "XYZ Long/Short Equity Fund" would require an 80% investment policy with respect to the "equity" component of the name. Regardless, even in the absence of the application of the Names Rule, the SEC states that "a fund must, consistent with rule 38a-1, adopt and implement written policies and procedures reasonably designed to prevent violations of the federal securities laws, which include section 35(d) and the [N]ames [R]ule."

Consistent with the current Names Rule, funds would be able to define terms used in their names in a reasonable way; however, in a change from the current rule, funds would be subject to a proposed requirement that any terms used in the fund's name that suggest an investment focus must be consistent with those terms' plain English meaning or established industry use. According to the SEC, what constitutes "reasonable" in this context could vary depending on the fund's name, but requires a "meaningful nexus" between the given investment and the focus suggested by the name. In other words, a fund cannot materially alter the plain meaning of words used in its name with disclosure.

Fund registration forms would be revised to require disclosures from funds subject to the Names Rule defining the terms used in their names, including the specific criteria, if any, used to select the investments that the term describes.

Increased Oversight of Temporary Departures

In a fundamental departure from the current Names Rule, the proposal would prescribe express circumstances under which a fund may deviate from its 80% investment policy and specify time frames for a fund to resume compliance with its 80% investment policy.

The revised Names Rule would permit deviations only:

1. as a result of market fluctuations, or other circumstances where the temporary departure is not caused by the fund's purchase or sale of a security, or the fund's entering into or exiting an investment;
2. to address unusually large cash inflows or unusually large redemptions;
3. to take a position in cash and cash equivalents or government securities to avoid a loss in response to adverse market, economic, political or other conditions; or
4. to reposition or liquidate a fund's assets in connection with a reorganization, to launch the fund, or when notice of a change in the fund's 80% investment policy has been provided to fund shareholders at least 60 days before the change pursuant to the Names Rule.

A fund would be required to come back into compliance with its 80% investment policy as "soon as reasonably practicable," but in no event more than 30 days following its initial departure in the case of items 1, 2 and 3 above, or 180 days following the fund's launch. The proposal does not include a specific time-frame for departures in connection with a fund reorganization on the theory that such transactions are fundamental changes to the nature of the fund entailing a lengthy process that is ordinarily robustly disclosed to shareholders. Similarly, changes to a fund's 80% investment policy do not include a specific time frame on the theory that this is a fundamental change to the nature of the fund that is disclosed to shareholders. Each of these situations, however, remain subject to the "as soon as reasonably practicable" standard.

[2] Final Rule: Investment Company Names, 1940 Act Rel. No. 24828 (Jan. 17, 2001), at section II.A.4.

According to the SEC, these parameters reflect its belief that investors' expectations for funds' investment focuses may not depend on whether market events negatively impact the investments in the fund's portfolio. As an example, the SEC observes that investors increasingly seek out funds that are structured as passive investment vehicles, such as index-based mutual funds and ETFs, in order to obtain specific types of investment exposure for their portfolios. The SEC opines that these investors may expect the fund to invest in a manner that is consistent with its stated investment focus with the understanding that investors may rebalance their own portfolios if desired rather than expecting the fund to do so. The SEC expresses the belief that, at some point, departures from an 80% investment policy may begin to change the nature of the fund fundamentally, which would undermine investor expectations created by the fund's name, and that the proposed time limits are designed to prevent such a fundamental change.

These new limits on departures from 80% investment policies, taken together with the expansion of the funds subject to the Names Rule, would fundamentally alter the regulatory structure that has governed fund names for 20 years. Potential consequences if the proposal is adopted in its current form could include disruption to existing investment strategies; forced portfolio management decisions divorced from that which may be most advantageous to shareholders; a move toward generic and uninformative fund names; time and expense in changing existing fund names and/or developing new or more detailed investment policies and/or strategies; and litigation challenging compliance with inherently subjective investment policies required by a revised Names Rule.

Fund managers should review the proposed changes closely and consider their impact, as well as the SEC's asserted bases for additional regulation and possible alternative solutions to achieve the same policy objectives in a less prescriptive manner that are perhaps more consistent with other recently adopted regulatory schemes for funds (*e.g.*, the Liquidity Risk Management Rule or Rule 18f-4's treatment of derivatives).

For example, one area where the SEC expressly requests comment is whether a revised Names Rule should instead provide that, if a temporary departure from an 80% investment policy persists past 30 days, the fund's board must approve, or be informed in writing about, the temporary departure. Other matters to consider could also include back-testing how the changes would have affected portfolio management in stressed market environments, such as the 2007-2009 financial crisis, the market volatility occasioned by the rise of COVID-19 in 2020 and the more recent volatility occasioned by rising inflation and the beginning of monetary policy normalization.

Treatment of Derivatives

For purposes of the 80% investment policy calculation, if a fund uses derivatives, the Names Rule proposal would require it to use the derivatives instrument's notional (rather than market) value when calculating the value of its assets (the denominator) and the value of its 80% basket (the numerator). Additionally, the fund would be required to reduce the value of its assets by excluding cash and cash equivalents up to the notional amounts of the derivatives instrument(s).

A "derivatives instrument" is defined to include any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar instrument. In calculating notional amounts for Names Rule purposes, a fund would be required to convert interest rate derivatives to their 10-year bond equivalents and to delta-adjust the notional amounts of options contracts.

In addition to allowing derivatives to be counted in a fund's 80% basket, because the derivatives provide exposure to the investments suggested by the fund's name, under the proposed changes, a fund may count a derivatives instrument that provides exposure to one or more of the market risk factors associated with the investments suggested by the fund's name. Thus, for example a fund investing in foreign markets can include currency hedging derivatives in its 80% basket and a credit fund could include interest rate derivatives it uses to manage, for example, its overall portfolio duration, according to the proposal.

According to the SEC, this result is appropriate because the derivatives instruments included in a fund's 80% basket would either be functioning as a substitute for direct investments in the securities suggested by the fund's name, or are used to facilitate the fund's investment in those securities by increasing or decreasing the fund's exposure to risk factors associated with those securities. Using the market rather than the notional value of the derivatives instrument would not meaningfully reflect the fund's exposure to investments suggested by the fund's name.

Treatment of Unlisted Funds

The changes would generally retain the rule that an 80% investment policy is changeable upon 60 days' prior notice to shareholders (except for a fund whose name suggests its distributions are tax-exempt, where the fund's 80% investment policy must be fundamental — *i.e.*, only changeable by a shareholder vote). The proposal would also require unlisted closed-end funds (including BDCs) subject to the revised Names Rule to make their 80% investment policy a "fundamental policy" in the case of an unlisted closed-end fund, or changeable only upon a vote of a majority of the outstanding voting securities, in the case of a BDC.[3] The SEC's reasoning is that advance notice is not effective in the case of unlisted closed-end funds (including BDCs) because their shareholders generally cannot use the time provided by the notice to exit their investments if they do not wish to remain invested after the change in the fund's investment policy.

This requirement that the 80% investment policy be treated as fundamental could create significant disruption for unlisted closed-end funds, including BDCs. In addition to the potential impacts discussed above, existing unlisted registered closed-end funds would need to contend with obtaining a "majority of the outstanding" shareholder vote in order to implement this new fundamental policy, and the inability to obtain such a vote could lead to serious disruption to these funds' investment strategies or market recognition (due to a need to change the fund's investment strategy or name if a vote cannot be obtained).[4]

For these and other reasons, market participants may want to consider pressing alternative options in the comment process, including those specifically raised by the SEC (*e.g.*, increased notice periods, compulsory tender offers), and opposing the expansion of these requirements to any other types of funds, on which the SEC has also requested comment.

Effect of Compliance with Revised Names Rule

Another proposed change would add a provision to the Names Rule making clear that a fund name may be materially deceptive or misleading under Section 35(d) of the 1940 Act even where the fund complies with its 80% investment policy. As examples, the SEC provides the following:

- a fund complies with its 80% investment policy but makes a substantial investment that is antithetical to the fund's investment focus (*e.g.*, a "fossil fuel-free" fund making a substantial investment in an issuer with fossil fuel reserves);
- a fund invests in a way such that the source of a substantial portion of the fund's risk or returns is different from that which an investor reasonably would expect based on the fund's name (*e.g.*, a short-term bond fund using the 20% basket to invest in highly volatile equity securities, despite the fact investors would expect low levels of volatility with short-term bonds);
- a fund that is perpetually out of compliance with the 80% investment requirement on account of temporary departures even if each temporary departure is permissible under the Names Rule.

Use of ESG Terminology in Certain Fund Names

The proposal contains a provision that prohibits so-called "integration" funds from using terms in their names that suggest the fund's investment decisions incorporate one or more ESG factors. "Integration" funds are funds that consider one or more ESG factors alongside other, non-ESG factors in the fund's investment decisions, but those ESG factors are generally no more significant than other factors in the investment selection process, so ESG factors may not be determinative in deciding to include or exclude any particular investment in the portfolio. The SEC would define the names of "integration" funds as materially deceptive and misleading if the name includes terms suggesting that the fund's investment decisions incorporate one or more ESG factors.

Modernization of Names Rule Notice Requirement

The proposal would amend the Names Rule's existing notice requirements related to changes in a fund's 80% investment policy:

- Notices must describe, as applicable, the fund's 80% investment policy, the nature of the change to the 80% investment policy, the fund's old and new names, and the effective date of any investment policy and/or name changes;
- When delivered in hard copy form, the required notice may be included in the same envelope as other documents, but would still be required to be a separate document;
- Notices must contain the following bold-face statement: "Important Notice Regarding Change in Investment Policy [and Name]" (or a similar clear and understandable statement). If the notice is delivered in hard copy form, the statement must also appear on the envelope and, if sent electronically, must appear in the subject line/heading of the communication that contains the notice.

[3] For registered funds, a "fundamental policy" is one changeable only upon a vote of majority of the outstanding voting securities. Under the 1940 Act, a "majority of the outstanding voting securities" means the vote at the annual or a special meeting (a) of at least 67% of the voting securities present at the meeting, if the holders of more than 50% of the outstanding voting securities of such company are present or represented by proxy; or (b) at least 50% of the outstanding voting securities of the company, whichever is less.

[4] See 1940 Act § 13(a)(3); cf. 1940 Act Rule 23c-3(b)(2)(iii) (addressing the "fundamental" status of existing funds' policies to make repurchases); Repurchase Offers By Closed-End Management Investment Companies, 1940 Act Rel. No. 19399 (Apr. 7, 1993), at text accompanying n.22 (adopting Rule 23c-3 and explaining that paragraph (b)(2)(iii) of the rule was intended to avoid requiring existing funds to obtain a shareholder vote to adopt the newly required fundamental policy). Sections 8 and 13 of the 1940 Act do not apply to BDCs.

N-PORT Reporting

The SEC proposes to amend Form N-PORT to require identification of the investments included in the 80% basket; disclosure of the value of the fund's 80% basket, stated as a percentage of the fund's assets; and, if the 80% basket fell below 80% of the fund's assets during the applicable reporting period, the number of days the fund was out of compliance.

Recordkeeping

Another proposed change would impose new recordkeeping requirements on all funds (including those that do not adopt an 80% investment policy), designed to allow the SEC to evaluate compliance with the proposed Names Rule's amended 80% investment policy provisions:

- A fund that adopts an 80% investment policy requirement would be required to maintain written records of: (1) any departures from the fund's 80% investment policy, including (i) the reasons for the departures and (ii) the dates of any such departures from the fund's 80% investment policy; (2) the investments included in the fund's 80% basket and the basis for including each such investment in the 80% basket; (3) the value of the fund's 80% basket, as a percentage of the value of the fund's assets; and (4) any notices provided to the fund's shareholders pursuant to the amended Names Rule; these records would be required to be maintained for at least six years following their creation (or, the case of notices, following the date the notice was sent), the first two years in an easily accessible place;
- A fund that does not adopt an 80% investment policy would be required to maintain written records related to the fund's analysis that an 80% investment policy is not required and maintain those records for at least six years following the fund's last use of the applicable name.

SEC Request for Comment: Regulatory Status of Certain Information Providers

On June 15, 2022, the SEC announced that it was requesting public comment on the regulatory status of certain information providers in the asset management industry, focusing, in particular, on index providers, model portfolio providers and pricing services (Information Providers) whose activities may under some circumstances bring them within the definition of "investment adviser" under the Investment Advisers Act of 1940 (Advisers Act). That would trigger registration and disclosure requirements under the Advisers Act and could invoke provisions under the 1940 Act. More broadly, the scope and range of the Information Providers' operational activities may affect national securities markets, the SEC said in the request, "to facilitate consideration of whether regulatory action is necessary and appropriate to further the Commission's mission."

"The role of these information providers today raises important questions under the securities laws as to when they are providing investment advice rather than merely information," SEC chair Gary Gensler said in a statement accompanying the request for comments.

Index Providers

Index Providers (IPs) are compensated to "compile, create the methodology for, sponsor, administer, and/or license market indexes" for market participants (User) to use in (1) the development of investment products, (2) in the public presentation of User investment product performance for marketing purposes, and (3) for required regulatory reporting purposes, such as where an investment company User is required to present one-, five- and 10-year performance information in its registration materials alongside "the returns of an appropriate broad-based securities market index."

The use of IPs' services and products varies across markets, from simple passive investing, where Users' products seek to track a broad-based securities index by investing in the same securities with the same weightings as the index, to more specialized products developed for a single User. The request indicates that, in some cases, an IP discloses its methodology, including criteria for investment selection, weightings and the timing surrounding its decision-making and rebalancing, thus limiting its discretion and giving all market participants and Users equal access to material information.

In other cases, however, IPs — particularly smaller firms — offer specialized, proprietary products for single Users. Likewise, for active indices with high turnover, IPs may exercise discretion as to what securities are included in the index, the timing of security selection, under what conditions the index is rebalanced, and the general input criteria used in the overall decision-making process, all with limited or no disclosure.

The request for comment states that IPs' products and services have the potential to affect the public securities markets, particularly when changes to an index becomes a timeable event, in which case they may provide front-running opportunities to Users and other market participants, or otherwise has a material impact on the average daily trading volume of securities bought and sold based on the IPs' decisions.

Certain IPs, particularly those with discretion to make active decisions and whose compensation is tied to the AUM of products tracking the IP's indices, may be engaged in providing investment advice under the Advisers Act for compensation, the SEC stated in seeking comments, and may have assets under management as defined in the act, and thus may trigger the act's registration requirements.

To the extent Users meet the definition of an investment company under the 1940 Act, or are investment advisers and do not qualify for exemptions or safe harbors under the definition of an investment company for certain advisory programs or implementing the IP's discretionary decisions for a group or pool of separately managed accounts, the SEC implied in the request for comments that the IP may be acting as an investment adviser to investment companies.

Due to the impact IPs have on the overall securities markets, the SEC makes it clear that it wants to understand the extent to which Users rely on IPs, how IPs classify their relationships with Users in agreements, public disclosures and published methodologies, particularly with respect to regulatory obligations and the characterization of the services offered, the discretion afforded to IPs and whether IPs tailor their decision-making to the individual needs of Users and/or Users' clients.

Model Portfolio Providers

Model Portfolios (Models) "generally consist of a diversified group of assets (often mutual funds or exchange-traded funds (ETFs)) designed to achieve a particular expected return with exposure to corresponding risks." Models can be developed internally by investment advisers and remain proprietary, or by other regulated entities, such as broker-dealers, advisers and third-party strategists and used exclusively for such registrants' own clients. Or they may be provided by third-party Model Portfolio Providers (MPPs).

In seeking comments, the SEC made reference to the fact that MPP product offerings for market participants (Users) range from general non-discretionary investment models furnished at regular set intervals (typically for a flat fee, subscription- or transaction-based fees) to more bespoke models developed in concert with a User (often for an on-going fee based on the User's assets under management that rely on the MPP's models).

Just as the SEC inquired about the role of Index Providers, it seeks to understand the market demographics of Users who rely on MPPs, and whether the level of discretion maintained by an MPP and the nature of the services passed through from the MPP to the User's clients and products brings the MPPs under the Advisers Act and 1940 Act. The agency also has inquired about undisclosed conflicts of interest, such as when an MPP includes a proprietary security in models offered to Users, thus resulting in the MPP receiving both security- and model-based compensation, and to what extent Users and MPPs currently characterize their respective statuses in agreements and disclosures governing or describing the relationship.

The request for comments makes it clear that, while investment advisers are permitted to narrow the scope of the relationship and services offered to clients by written agreement, they are not permitted to outsource their fiduciary obligations with respect to those services and clients to the extent the services constitute investment advice under the Advisers Act.

Pricing Services

The SEC also seeks to understand the nature and services offered by Pricing Services Providers (PSPs). Specifically, the agency wants to identify: how PSPs are used, by whom and under what facts and circumstances; the relationship between consumers of such information (Users) and the PSPs, particularly where Users are able to exercise substantial influence over the PSP's decision-making process; inputs relied upon by the PSP; and other material considerations with respect to investment advisers and investment companies; and whether Users have made proper disclosure to clients and shareholders whose investments are subject to the PSP's decisions and fees.

As with the SEC's request for comments about IPs and MSPs, the agency seeks to understand to what extent registrants conduct diligence and reviews of PSPs; the factors reviewed in the diligence conducted; how conflicts of interest are addressed in agreements governing the relationships, related disclosures and registrants' corresponding policies and procedures related to PSPs; discrepancies in the pricing of the same security across different PSPs; and the Users' oversight and testing of PSPs' effectiveness, controls and compliance with agreements and disclosures.

Takeaways

The scope of any SEC initiative growing out the comments remains to be seen. That said, the request for comments offers a reminder that agreements governing relationships between market participants, registrants and IPs should be thoughtfully reviewed and negotiated, and should clearly outline the roles and responsibilities of each of the parties. The request for comments offers a roadmap of potential issues industry participants should address, such as the discretion maintained and reserved by each party, the characterization of the services and whether the services constitute regulated activity.

Electronic Submissions Proposal

On June 23, 2022, the SEC unanimously voted to adopt rules to update filing requirements to require the electronic filing or submission of certain documents by investment advisers, institutional investment managers and others that are currently filed on paper. The SEC simultaneously voted to amend Form 13F to modernize and enhance the information reported on the form.

The new rules and form amendments are intended to enhance efficiency and transparency, and to make disclosure more operationally resilient. The SEC explains that the purpose of the rule and form amendments is to address logistical and operational issues raised by the spread of COVID-19 and allow the public to access electronic filings in easily searchable formats.

These changes come shortly after recent SEC rule amendments that require all registrants to submit via EDGAR a variety of other documents, including Form 144 filings and annual reports to security holders (referred to as "glossy" annual reports). SEC Chairman Gary Gensler remarked on the rules on the day of their approval, stating "I was pleased to support these amendments because they will modernize and increase the efficiency of the filing process for filers, investors, and the SEC."

The rules and form amendments apply to RIAs, institutional investment managers and others that file or submit reports to the SEC on EDGAR or the Investment Adviser Registration Depository (IARD) system.

Specifically, the rule and form amendments will require the electronic filing or submission of: applications for orders under the Advisers Act on EDGAR; confidential treatment requests for Form 13F filings on EDGAR; and Form ADV-NR through the IARD system. (Form ADV-NR is a form used by non-resident general partners and non-resident managing agents of an investment adviser to designate an agent for service of process in the U.S.) Under Section 13(f) of the Securities Exchange Act of 1934 (1934 Act), an institutional investment manager is required to file a Form 13F if the manager exercises investment discretion over accounts holding 13(f) securities with an aggregate fair market value on the last trading day of any month of any calendar year of at least $100 million. The amendments also add optional reporting of a Financial Instrument Global Identifier for any security reported on Form 13F, as well as certain technical amendments to Form 13F that enhance the information reported.

The SEC is providing a six-month transition period to provide advisers, applicants and managers sufficient time to modify their procedures. With the exception of the amendments to Form 13F, the new rules and form amendments will be effective August 29, 2022. The amendments to Form 13F will be effective January 3, 2023.

Proposed Amendments to Shareholder Proposal Rules

On July 13, 2022, the SEC proposed amendments that would modify the standards under which companies may exclude shareholder proposals from their proxy statements. The proposed changes to the "substantial implementation," "duplication" and "resubmission" tests likely would increase the number of shareholder proposals received by companies and make it less probable that the proposals could be excluded. Public comments are due by mid-September 2022.

See our July 15, 2022, client alert, "SEC Proposes Amendments to the Shareholder Proposal Rules."

SEC Rescinds Certain 2020 Amendments to Rules Governing Proxy Advisors

On July 13, 2022, the SEC, by a 3-2 vote, adopted amendments to the rules governing proxy voting advice businesses (proxy advisors), rescinding two components of the proxy rules adopted in 2020. The amendments rescind (i) certain conditions that proxy advisors would have to satisfy for their voting recommendations to be exempt from proxy information and filing requirements and (ii) an explanatory note illustrating instances in which proxy advisor voting recommendations may run afoul of the anti-fraud provisions of the proxy rules.

See our July 14, 2022, client alert, "SEC Rescinds Certain 2020 Amendments to Rules Governing Proxy Advisors."

On July 28, 2022, the U.S. Chamber of Commerce sued the SEC, challenging this action. The Chamber alleges that the SEC failed to explain the rationale for their reversal, did not engage in appropriate rulemaking processes, and thus failed to comply with the Administrative Procedure Act.

SEC Publishes Regulatory Agenda

On June 22, 2022, the SEC issued its Spring Regulatory Agenda, which includes more than 50 proposed regulations on a range of social and economic topics, with a variety of rules implicating the Advisers Act and the 1940 Act.

Final stage rules include topics such as:

- climate change disclosure,
- cybersecurity risk governance,
- proxy voting advice,
- money market fund reforms,
- amending Form PF to expand reporting requirements for all private fund and some hedge fund advisers,

- additional regulation of conflicts of interest and preferential treatment of investors for private fund advisers,
- streamlining of disclosure and periodic reporting under the 1940 Act with respect to shareholder reports,
- annual prospectus updates and fee and risk disclosure, and
- enhanced proxy vote reporting by registered funds.

Rules at the proposal stage include topics such as:

- changes to the Names Rule for regulated funds,
- rules for investment companies and advisers related to ESG factors,
- mutual fund liquidity and dilution management,
- Advisers Act custody rule amendments,
- corporate board diversity,
- human capital management disclosure,
- SPACs,
- fund fee disclosure and reform,
- amendments to shareholder proposal rules,
- amendments to Regulation D,
- amendments to the definition of securities "held of record" under Section 12(g) of the 1934 Act, and
- digital engagement practices for investment advisers.

A number of these have been discussed above.

In a statement, SEC Commissioner Hester Pierce criticized the agenda, saying it "continues to shun issues at the core of our mission in favor of shiny objects outside our jurisdiction." She cited, in particular, proposed disclosure requirements regarding board diversity, climate-related risk and human capital management.

Compliance Date Reminders

As we noted in our May 2022 Investment Management Update, RICs, BDCs and investment advisers must be prepared to comply with three new final rules with 2022 compliance dates.

Good Faith Determinations of Fair Value Under the 1940 Act

On September 8, 2022, RICs and BDCs must begin complying with the SEC's new good faith fair valuation framework for portfolio holdings, Rule 2a-5 under the 1940 Act.

By that deadline, funds and their boards must formally adopt and implement required changes to their compliance policies and procedures related to their fair valuation methodologies and, if desired, designate the investment adviser as "valuation designee." These include functions contemplated by the rule to periodically assess material risks associated with making fair valuation determinations, establishing and applying effective methodologies, developing testing procedures to ensure accuracy and appropriateness, and managing the board reporting and oversight of the valuation designee (if applicable) and any pricing services that are used for inputs in the process.

See "SEC Modernizes Fund Valuation Framework" in the December 2020 issue of this newsletter.

Use of Derivatives by Registered Investment Companies and Business Development Companies

As of August 19, 2022, RICs and BDCs must begin complying with the SEC's new derivatives risk management framework, Rule 18f-4 under the 1940 Act, related to funds' use of, or participation in, derivatives transactions.

Under the rule, funds and their boards must formally adopt and implement required changes to their compliance policies and procedures related to their management of derivatives risk and the framework articulated by the rule. These include, where relevant, ensuring that:

- implemented changes meet or exceed the required scope of a comprehensive derivatives risk management program set forth in the rule;
- any calculations related to eligibility determinations for limited derivatives users are verified for accuracy and approved by fund boards, where appropriate; and
- any policies and procedure related to testing and reporting have been reasonably designed to prevent, detect and correct violations of the Rule, consistent with existing compliance obligations under the 1940 Act's compliance rule, Rule 38a-1.

See our November 23, 2020, client alert, "SEC Adopts Rules for Use of Derivatives by Registered Investment Companies."

Investment Adviser Advertisements; Compensation for Solicitations

On November 4, 2022, investment advisers that are registered or required to be registered with the SEC must begin complying with amended Rule 206(4)-1 under the Advisers Act, the primary principles-based rule set to govern the advertising and solicitation activities of registered investment advisers.

The rule requires that registered advisers formally adopt and implement required changes to their compliance policies and procedures related to their advertising and solicitation activities. These include, to the extent relevant, activities related to the calculation and presentation of any hypothetical, back-tested model or extracted performance. Registered advisers should also review and amend, to the extent necessary, agreements and disclosures governing solicitation activities, third-party endorsements, ratings and promoter functions.

See "SEC Adopts Modernized Marketing Rule for Investment Advisers" in the June 2021 issue of this newsletter.

Litigation Updates

SEC Division of Enforcement Focusing on Advisory Contract Approval Process

As we noted in the May 2022 edition of this newsletter, SEC Division of Investment Management Director William Birdthistle delivered prerecorded remarks at the Investment Company Institute's 2022 Investment Management Conference where he raised concerns that fund investors do not currently have the sufficient tools and resources necessary to independently evaluate their fund investments on an ongoing basis. In this speech, he made an express reference to funds that underperform relative to their peer group and benchmark, and charge above-average management fees.

Mr. Birdthistle referenced Section 36(b) of the 1940 Act as both a private right-of-action option for investors and enforcement option for the SEC, noting, however, that no plaintiff has prevailed in a private claim. In discussing the fail rate of private litigants bringing actions under Section 36(b), Mr. Birdthistle cited the SEC's power and authority to bring actions under Section 36(b), again in the context of underperforming, higher-fee funds.

Mr. Birdthistle refreshed his concerns most recently on July 26, 2022, at the Practicing Law Institute's 2022 Investment Management Program, where he once again delivered prerecorded remarks to industry professionals. During the initial part of the address, Mr. Birdthistle reiterated his concerns about opaque fee structures and the lack of investor resources to monitor investments in registered funds.

It was recently reported in various media outlets that the SEC Division of Enforcement has been sending out document requests to fund complexes seeking information regarding which personnel at the adviser are involved in the 15(c) process for approval of investment advisory agreements and what responsibilities each has with regard to the process; all board meeting materials related to the 15(c) process; any 15(c) process-related materials given to any director or trustee; documentation related to the board's findings that fees are reasonable; and documentation regarding profitability.[5]

While there has been no confirmation of a formal sweep exam or an initiative related to Mr. Birdthistle's concerns, all industry participants should pay attention to what comes out of these document requests. These revelations and newfound focus from the SEC also present an opportunity for boards and investment advisers to take another hard look at their 15(c) process and make sure (i) robust policies are in place for setting fees, (ii) the *Gartenberg/Jones*[5] factors are being fully evaluated, (iii) that boards obtain, and advisers provide, relevant materials that support the evaluation of these factors and (iv) that the 15(c) process is well documented.

Fifth Circuit Find SEC Securities Fraud Enforcement Actions Violate the Constitution

The Fifth Circuit recently held that the SEC's practice of enforcing securities fraud violations through an enforcement action in front of an SEC administrative law judge is unconstitutional.

In *Jarkesy v. SEC,* No. 20-61007 (5th Cir. May 18, 2022), a hedge fund manager and investment advisor who were found to have engaged in securities fraud by an SEC administrative law judge (SEC ALJ) appealed, arguing that the SEC violated several constitutional protections by adjudicating the matter before an SEC ALJ. In a 2-1 opinion, the Fifth Circuit agreed with

[5] The "15(c) process" refers to Section 15(c) of the 1940 Act, which sets forth the formal process for boards to evaluate and approve (or reapprove) investment advisory contracts with registered investment companies.

[6] *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F. 2d 923, 928–930 (2nd Cir. 1982); *Jones v. Harris*, 559 U.S. 335 (2010)

the petitioners, finding that: "(1) Petitioners were deprived of their constitutional right to a jury trial; (2) Congress unconstitutionally delegated legislative power to the SEC by failing to provide it with an intelligible principle by which to exercise the delegated power; and (3) statutory removal restrictions on SEC ALJs violate Article II" of the Constitution. Judge W. Eugene Davis disagreed with the panel on all three grounds.

First, the Fifth Circuit held that the SEC violated the petitioners' Seventh Amendment right to a jury trial. The court explained that actions for securities fraud are not uniquely suited for agency review because, among other reasons, they were regularly brought in federal courts when the Seventh Amendment was ratified. Moreover, the court explained that the civil penalties often sought by the SEC (and those sought in this particular case) were legal remedies that were subject to the protections of the Seventh Amendment.

Second, the court held that Congress' grant to the SEC of the option to proceed via internal administrative proceedings or through an Article III court was an unconstitutional delegation of legislative power. The Fifth Circuit said that deciding how to adjudicate violations of law was an inherently legislative act. By allowing the SEC to choose, in effect, how to adjudicate illegal activity, the court held, Congress had failed to give the SEC an "intelligible principle" constraining its discretion. Hence, the SEC's exercise of discretion violated the Constitution's separation of powers.

Finally, the court held that the fact that an SEC ALJ could only be terminated for good cause was an unconstitutional constraint on the President's authority to take care that the laws are faithfully executed.

The SEC has asked the Fifth Circuit to reconsider the panel's decision *en banc*. That request remains pending.

SEC Division of Enforcement Director Grewal Offers Commentary on Cooperation

SEC Division of Enforcement Director Gurbir S. Grewal offered his thoughts on the balance between zealous advocacy and cooperation in SEC investigations and enforcement actions in a keynote address at the Securities Enforcement Forum West 2022 on May 12, 2022.

In particular, Director Grewal spoke about the impact of perceived delay by defense counsel and emphasized the need for defense counsel to build trust with the SEC staff throughout investigation and enforcement proceedings. He provided several examples of actions that may undermine such trust, including delayed or inadequate document productions and unsupported assertions of attorney-client privilege. He said that he "fully appreciate[s] and welcome[s] zealous advocacy," but "dilatory or obstructive conduct," among other things, "frustrates [the SEC's] processes, puts investors at risk, and contributes to … declining [public] trust." Director Grewal concluded his keynote address by emphasizing that it is in the "collective interest" of the SEC staff and defense counsel "to ensure that [SEC] investigations move quickly and efficiently."

SEC Personnel Updates

Mark T. Uyeda and Jaime Lizárraga Confirmed as SEC Commissioners

On June 16, 2022, the U.S. Senate confirmed President Joe Biden's two nominees to the SEC: Mark T. Uyeda (Republican) and Jaime Lizárraga (Democratic).

Earlier this year, President Biden nominated Commissioner Lizárraga to fill the seat which will be open after the departure of SEC Commissioner Allison Herren Lee, and Commissioner Uyeda to fill the seat vacated by former Commissioner Elad Roisman. Their confirmations provide the commission with a full five-member slate and do not alter the political balance of the commission.

Commissioner Lizárraga will leave his current role as senior adviser to Speaker of the House Nancy Pelosi, where he worked on legislation including COVID-19 relief measures, the Dodd–Frank Wall Street Reform and Consumer Protection Act, omnibus appropriations bills and the Economic Emergency and Stabilization Act of 2008.

Commissioner Uyeda has served on the staff of the SEC for over 15 years, including as senior advisor to Chairman Jay Clayton, senior advisor to Acting Chairman Michael S. Piwowar, counsel to former Commissioner Paul Atkins and has held various staff positions in the Division of Investment Management. He most recently served on detail from the SEC to the Senate Committee on Banking, Housing and Urban Affairs as a securities counsel to the committee's minority staff. He is the first Asian-Pacific American to serve as a commissioner at the SEC.

Acting Director of SEC Division of Examinations Made Permanent

On May 24, 2022, the SEC announced that the interim appointment of Richard R. Best as Director of the Division of Examinations would be made permanent. Best had served as the division's acting director since March 23, 2022, when Daniel S. Kahl announced his departure after more than 21 years at the SEC. SEC Chair Gensler commented: "Our examinations program — acting as eyes and ears on the ground for the Commission — is critical for our capital markets to function well and keep the public's trust. Rich's experience leading three different SEC offices gives him perspective and relationships across the agency that will be invaluable to the Division."