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Closed-End Fund Activism Update

Activist investors continue to take large positions in closed-end funds and engage in disruptive activity that may be harmful to long-term shareholders of retail closed-end funds. This trend, which has occurred over the past several years, has continued apace for the 2023 closed-end fund annual meeting season and in some respects appears to be accelerating. Just this year we have seen activist closed-end fund investors nominate dissent slates of directors and submit shareholder proposals seeking, among other things, to terminate advisory agreements, declassify boards, amend bylaws, adopt plurality voting standards in contested elections, eliminate the applicability of "control share" statutes, conduct quarterly tender offers and merge with existing open-end funds. These activities are in addition to several active litigations among closed-end funds and activists challenging (a) director election standards, (b) the application of bylaw provisions requiring advance notice of director nominations and (c) the legality of "control share" provisions, including a recent action filed against 16 different closed-end funds.[1]

We are also seeing certain activists run highly sophisticated traditional media and social media campaigns as part of their litigation and proxy solicitation efforts — a key new development to note. This development highlights the importance of boards and managers engaging with a fund's shareholders on an ongoing basis. Building a rapport with a fund's shareholder base though consistent outreach can pay key dividends when a fund is faced with a barrage of traditional and social media attacks on the board or the adviser.

Negative Impact on Retail Closed-End Fund Investors

Understanding the threat this activist activity poses starts with first understanding that this activism is generally not the type of "good governance" activism that might arise in the non-investment company context. Generally, this activism is designed to make significant profits for wealthy hedge fund investors at the expense of the closed-end fund as an important middle-class investment tool. Some activist funds often have a considerable amount of capital available to run a simple activist strategy: Closed-end funds usually trade on a securities exchange at a discount to the net asset value (NAV) of their portfolios — buying at a discount and then seeking a transaction that results in a sale at closer to net asset value results in an instant profit. Activists use the types of governance-related proposals and arguments described above as "straw men" to apply pressure on a closed-end fund's board to engage in one of these "NAV-realizing" transactions. Examples include a single or periodic tender offers for shares at or just below NAV, conversion to an open-end fund structure (open-end funds are required to redeem shares on demand at NAV), a fund liquidation or commitments to make fixed distributions that result in returns of capital.

This activity is resulting in significant negative consequences for closed-end funds and their middle-class investors. According to the Investment Company Institute (ICI), hostile activist activity has become more common and concentrated. The ICI notes that compared with the prior four-year period, the number of beneficial ownership and contested proxy solicitation filings indicating shareholder activism increased from 2018 to 2022, despite there being fewer exchange-listed closed-end funds. A more telling statistic from the ICI is that 95% of these filings were concentrated among only five activists, compared to 53% of the filings coming from the top five activists from 1998 to 2002. This indicates that the "business" of closed-end fund activism is consolidating and growing, particularly given the substantial financial resources of this new breed of activists. Deep pockets allow the activists to finance multiyear campaigns, sophisticated media strategies and protracted litigation against closed-end funds as a means to both apply pressure on boards to capitulate in the face of mounting costs and to achieve what appears to be a newly common goal: the full takeover of closed-end funds.

[1] See our February 2023 Investment Management Update for more detail on these matters.

In a full takeover of a closed-end fund: the activist succeeds in obtaining a majority of the board seats; typically any remaining directors not affiliated with or nominated by the activist resign; the new board terminates the fund's existing adviser and hires a manager affiliated with the activist (or the activist itself); and the new board and adviser radically change the fund's investment strategy. This benefits the activist by providing a profitable new stream of fee revenue and another vehicle to support further activism.

The ICI highlights the harms this activity sows on middle-class closed-end fund shareholders:

> "Depending on what actions activists force, CEFs' long-term shareholders may find themselves invested in a radically different product with an entirely new strategy, the same product but with fewer assets and correspondingly higher fees and expenses, or no product at all. Moreover, asset management firms have been reticent to launch new CEFs given growing activist threats, raising concerns among ordinary investors about the sustainability of the CEF market."[2]

To that point, some of the more recent activist campaigns have targeted funds launched in the past two to three years.

These impacts are also negative for middle-class closed-end fund shareholders because closed-end funds can provide needed diversification into private and less-liquid assets that can furnish greater income and returns not otherwise available to ordinary investors. The orientation of closed-end funds toward income-producing assets, and thus regular dividends, also helps investors in need of consistent cash flow. Importantly, investors' ability to invest in closed-end funds at a market price that is a discount to NAV, while receiving dividends based on their shares' NAV, results in bargain-priced yields for ordinary investors. Activists fail to recognize this dynamic when they use a closed-end fund's trading discount as a "straw man" for poor manager performance. Rather, it is that very trading dynamic that benefits many ordinary investors seeking income from their closed-end fund investments.

Section 17(d) — Joint Transaction Issues

The tactics and approach of activists described above raise serious issues under Section 17(d) of the Investment Company Act of 1940 (1940 Act) and Rule 17d-1 thereunder. A plain reading of the 1940 Act indicates that related private funds having the same investment adviser, and the investment adviser itself, are all **affiliated persons**, or **affiliated persons of affiliated persons**, of an acquired closed-end fund when one or several of them, acting in concert, acquires in excess of 5% of the outstanding voting securities of the acquired closed-end fund, and thus are all subject to the restriction on joint transactions set forth in Section 17(d) of the 1940 Act and Rule 17d-1 thereunder. The U.S. Securities and Exchange Commission (SEC) has expressly stated that "Section 17(d) of the [1940] Act was designed to prevent affiliated persons from exerting undue influence over investment companies by causing them to engage in transactions that confer disparate benefits on such persons."[3] Moreover, Section 1(b) of the 1940 Act states:

> "[I]t is declared that the national public interest and the interest of investors are adversely affected … (2) when investment companies are organized, operated, managed, or their portfolio securities are selected, in the interest of directors, officers, investment advisers, depositors, **or other affiliated persons thereof**, in the interest of underwriters, brokers, or dealers, in the interest of special classes of their security holders, or in the interest of other investment companies or persons engaged in other lines of business, rather than in the interest of all classes of such companies' security holders; … It is declared that the policy and purposes of this subchapter, in accordance with which the provisions of this subchapter shall be interpreted, are to mitigate and, so far as is feasible, to eliminate the conditions enumerated in this section which adversely affect the national public interest and the interest of investors."

The closed-end fund industry may wish to encourage the SEC to enforce the important protections Section 17(d) and Rule 17d-1 provide to the vast and diverse base of middle-class investors holding the bulk of closed-end fund equity securities, or to, at a minimum, engage in a rulemaking addressing appropriate conditions under which activist activity would not violate Section 17(d) and Rule 17d-1. Activists often cite the above provision of the 1940 Act (Section 1(b)) as support for their argument that their activities are needed to "hold managers accountable" and "protect" retail shareholders. What some activists fail to recognize, however, is that **they are the affiliated persons seeking a disparate benefit from the fund from whom the 1940 Act needs to protect the shareholder base at large**.

Corporate Hygiene

These considerations are a reminder that continuous attention to "corporate hygiene" is critically important for closed-end funds. Boards should carefully review provisions in their funds' governing documents addressing director/trustee elections, annual and

[2] *ICI Viewpoints*, "Shareholder Activism Threatens Closed-End Funds and Their Investors" (May 24, 2023).

[3] In the Matter of Sequoia Partners, L.P., Investment Company Act Release No. 20644 (Oct. 20, 1994).

special meetings, director/trustee qualifications, shareholder voting rights and proposals, as well as the applicability of any control share provisions. Boards need to consider whether the collective effect of these provisions provides adequate protection to the fund's shareholders from a vocal minority investor exerting undue influence to either (i) secure transactions or changes to the fund that are beneficial to that investor but not necessarily to all shareholders or (ii) secure a full takeover of the fund without providing shareholders with adequate information on the minority investor's plans for the fund.

Maryland Statutory Trusts — Applicability of Maryland Control Share Acquisition Act (MCSAA)

Recently passed amendments to the Maryland Statutory Trust Act specify that the Maryland Control Share Acquisition Act applies to a closed-end fund formed as a Maryland statutory trust on or after October 1, 2023, without the need for any action by the fund's board of trustees or any specific provisions in the fund's governing documents. These amendments further specify that the governing instrument of a closed-end fund formed as a Maryland statutory trust before October 1, 2023, may provide that the MCSAA applies to the statutory trust. Under the Maryland Statutory Trust Act, a "governing instrument" would include a fund's bylaws.

Each of these provisions function to establish a statutory basis for a closed-end fund organized as a Maryland statutory trust to avail itself of the MCSAA. Generally, control share statutes provide a company with the right to prevent or restrict certain changes in corporate control by limiting voting rights of a person that acquires, directly or indirectly, the ownership of or the power to direct the vote of "control shares" as defined in the specific state control share statute. "Control shares" are shares of stock that are equal to or exceed specified percentages of the company's total voting power. The MCSAA contains thresholds at (i) one-tenth or more, but less than one-third of all voting power; (ii) one-third, but less than a majority of all voting power; and (iii) a majority or more of all voting power.

Section 18(i) of the 1940 Act provides, "Except … as otherwise required by law, every share of stock … shall be a voting stock and have equal voting rights with every other outstanding voting stock." These Maryland amendments are important because Section 18(i) unambiguously allows for exceptions grounded in law, and these amendments provide further support for closed-end funds that are organized as Maryland statutory trusts to utilize the MCSAA.[4]

[4] See our February 2023 Investment Management Update for more detail on these matters.

The Liquidity Rule Enforcement Action: Thematic Takeaways and Interval Fund Opportunities

On May 5, 2023, the SEC filed a complaint in federal district court charging Pinnacle Advisors LLC for aiding and abetting violations of Rule 22e-4 (the Liquidity Rule) under the 1940 Act by a mutual fund that the company advised and whose Liquidity Risk Management Program it administered. The SEC also charged the fund's two independent trustees, Mark Wadach and Lawton "Charlie" Williamson, and two officers of both Pinnacle Advisors and of the fund it advised, Robert Cuculich and Benjamin Quilty, with aiding and abetting Liquidity Rule violations by the fund. A third trustee, Joseph Masella, agreed to settle charges that he caused the violations and willfully counseled the fund regarding them.

This enforcement action is notable because it is the first case enforcing the Liquidity Rule, which the SEC adopted in 2016. The case is also significant because the SEC charged the fund's independent trustees who, according to the SEC, recklessly failed to exercise reasonable oversight of the fund's liquidity risk management program.

The Liquidity Rule prohibits mutual funds from investing more than 15% of their net assets in illiquid investments, requires funds to take certain prompt remedial steps if they hold illiquid investments above this percentage limit and requires funds to adopt a liquidity risk management program to assess their liquidity risks. The SEC's complaint alleges that, from June 2019 to June 2020, the fund held approximately 21% to 26% of its net assets in illiquid investments. According to the complaint, Pinnacle Advisors and its officers, Mr. Cuculich and Mr. Quilty, classified the fund's largest illiquid investment as a "less liquid" investment, ignoring restrictions, transfer limitations and the absence of any market for the shares and disregarding the advice of fund counsel and auditors. The SEC alleges that Pinnacle Advisors and its officers did not present the fund's board with a plan to reduce the fund's illiquid investments to 15% or lower or make required filings with the SEC, as required by the Liquidity Rule. The complaint also states that Messrs. Cuculich, Quilty and Masella misled the SEC's Division of Investment Management about the basis for the fund's liquidity classifications. According to the complaint, Messrs. Wadach and Williamson, who knew that the shares were restricted and illiquid, aided and abetted the fund's violation by recklessly failing to exercise reasonable oversight of the fund's liquidity risk management program.

The SEC's complaint seeks permanent injunctions and civil money penalties. The fund is now a liquidating trust and is not separately charged.

The facts of this complaint, if they are true, represent a relatively straightforward case of violating the Liquidity Rule, as well as a failure of the independent trustees' oversight role. The more interesting aspects of this enforcement case are the thematic messages it appears to be sending, and what practitioners might conclude about future of the Liquidity Rule and the SEC's approach to it.

The Role of Independent Trustees/Directors

The SEC appears to be aggressively pursuing matters that fall within its thematic emphasis on resiliency and transparency as key drivers of a functioning market. This action highlights yet another dimension of that emphasis, which is the role independent trustees/directors play in helping achieve that resiliency and transparency. The SEC has long emphasized the role of independent trustees/directors as that of "independent watchdogs" who should furnish an independent check on the management of funds, represent shareholder interests in fund affairs and play a critical role in policing the potential conflicts of interest between a fund and its investment adviser.[5] When independent trustees/directors do not fulfill this role, as appears to be the case in the Pinnacle situation, resiliency and transparency are lost. Another example fitting this theme and addressing independent trustees/directors is the SEC staff's increased

[5] See, *e.g.*, *Interpretive Matters Concerning Independent Directors of Investment Companies*, 1940 Act Rel. No. 24083 (Oct. 14, 1999).

focus over the past year on the advisory contract approval process, which we last noted in October 2022. One key takeaway here is that independent directors/trustees should view this enforcement action as a reminder of the critical oversight role the SEC expects them to play for registered fund shareholders.

Impact of Proposed Liquidity Rule Amendments

As we noted in April 2023, the SEC staff has indicated that mutual fund liquidity is a crucial part of this thematic approach, which has been expressed though the SEC's proposal to amend the Liquidity Rule. We previously discussed these proposed amendments to the Liquidity Rule in February 2023 and April 2023. The Pinnacle enforcement action serves to further emphasize the SEC's commitment to its enhanced mutual fund liquidity agenda and to make clear that independent trustees/directors will be held accountable for oversight of funds' liquidity risk management programs. While that may only entail enforcement actions in the most egregious cases, accountability could also come in the form of enhanced scrutiny during exams, deficiency letters and even private plaintiff actions based on state law fiduciary claims. Independent trustees/directors should ensure that robust oversight practices are in place.

If the SEC adopts amendments to the Liquidity Rule, as proposed, advisers and independent trustees/directors will face more prescriptive liquidity risk management requirements and a broader swath of strategies that may be considered inappropriate for the open-end mutual fund structure under these liquidity risk management requirements. Further details on these impacts are available in our April 2023 update. The potential enhanced scrutiny portended by this enforcement action, together with the SEC's overall thematic approach may result in advisers and independent trustees/directors being more conservative when evaluating funds or strategies that may be on the margins from a mutual fund liquidity risk management perspective under an amended Liquidity Rule.

The question then arises of how to maintain retail investor access to strategies such investors desire for their own personal portfolios, while maintaining a common investor experience. Closed-end interval funds, which we've discussed before, can fill this need while preserving reasonable flexibility on the liquidity front (for the investor and for portfolio management) and eliminating the potential enhanced scrutiny that comes with Liquidity Rule compliance.

Potential Impact on Interval Fund Growth

An interval fund typically is not exchange-listed and is required, by "fundamental policy,"[6] to offer to repurchase 5%-25% of its shares, at net asset value, on a periodic basis (quarterly, semiannually or annually). While an interval fund is not subject to the Liquidity Rule, it is subject to a more flexible liquidity requirement that, during the pendency of a repurchase offer, a percentage of the fund's assets equal to at least 100% of the repurchase offer amount must consist of assets that can be sold or disposed of in the ordinary course of business, at approximately the price at which the fund has valued the investment, within a period equal to the period between a repurchase request deadline and the repurchase payment deadline, or of assets that mature by the next repurchase payment deadline.[7] An interval fund's board must also adopt written procedures reasonably designed, taking into account current market conditions and the fund's investment objectives, to ensure that the fund's portfolio assets are sufficiently liquid so that the fund can comply with its fundamental repurchase policy and the liquidity requirements articulated above. These procedures do not have to be compliant with the Liquidity Rule and can be tailored to a fund's particular liquidity profile in light of its fundamental repurchase policy, which could serve to reduce regulatory risk on advisers and independent trustees/directors in certain strategies relative to a mutual fund if the SEC adopts its proposed Liquidity Rule amendments.

Additionally, a variety of developments over the past several years have also made the interval fund investor experience more like the mutual fund investor experience. Interval funds routinely obtain SEC exemptive relief to sell multiple classes of shares to tap different distribution channels.[8] Interval fund shares can also be sold and repurchased through the National Securities Clearing Corporation, just like mutual funds. Distribution partners in the investment industry continue to slot interval funds into retail distribution channels instead of in an alternatives space where heightened suitability requirements may limit uptake. As a result, the distribution-related fee and expense structure of interval funds is often similar to that of mutual funds.

Advisers and independent trustees/directors may wish to begin considering these types of alternative product structuring options, and potential product conversions, in light of the heightened regulatory focus on enhanced liquidity in mutual fund portfolios. One frequent critical regulatory narrative about mutual funds is that they engage in "liquidity transformation" by allowing investors to purchase or redeem shares daily while holding assets that are generally less liquid.[9] Interval funds address this criticism by providing a structure that regulators may view as more closely matching investor liquidity options and portfolio liquidity. Interval funds are also a growing asset class, with trade publications reporting a

[6] A "fundamental policy" is an investment policy that can only be changed with a shareholder vote under the 1940 Act.

[7] The maximum time frame between a repurchase request deadline and a repurchase payment deadline is 21 days.

[8] 1940 Act Rule 18f-3 only allows open-end mutual funds to issue multiple classes of shares; thus, closed-end funds must obtain exemptive relief to do so.

[9] See, *e.g.*, Commissioner Mark Uyeda's Remarks to Investment Company Institute 2023 Investment Management Conference (March 20, 2023).

237% increase in assets from 2017 to 2022 and $81.3 billion in assets across 79 funds at the end of 2022. Additionally, while open-end to closed-end conversions, or the eschewing of a workable open-end product structure for a closed-end product structure, have historically been rare, the cost/benefit analysis from the considerations above, coupled with a continuing obligation to evaluate the appropriateness of the open-end structure for a fund under an amended and more prescriptive Liquidity Rule, may create a case that compels retail investors to trade the opportunity for daily liquidity for a reasonable amount of periodic liquidity and the continued availability of important and desired investment options. These conditions may in turn compel advisers and independent trustees/directors to build interval fund product lines.

LIBOR Transition Risk Alert

On May 11, 2023, the SEC Division of Examinations (the Division) issued a risk alert relating to investment advisers' and investment companies' preparedness for the cessation of LIBOR on June 30, 2023. Until now, SEC-registered investment advisers, broker-dealers and investment companies throughout the United States have used LIBOR as a benchmark rate in commercial and financial contracts. Since 2020, the Division has been examining registrants' transition plans and evaluating their LIBOR exposure, disclosures, operational readiness, conflicts of interest and efforts to shift to an appropriate alternative reference rate. The Division anticipates that registrants with transition plans will be more successful in mitigating any adverse effects associated with LIBOR cessation.

The May 2023 SEC risk alert provides an overview of the Division's examination results. The Division examined various firms, including: (i) advisers of large bank complexes; (ii) advisers to registered investment companies, such as mutual funds, closed-end funds, exchange-traded funds and business development companies; (iii) fund complexes of all sizes; (iv) advisers to private funds investing in private credit (*e.g.*, collateralized loan obligations); and (v) large retail advisers.

The Division observed that the firms should prepare for the transition by:

- Establishing internal risk assessment committees responsible for determining the most significant financial and operational risks and developing timelines to address them.
- Closely following the development of the Alternative Rate Reference Committee's LIBOR guidance. The Division suggested firms consider joining industry associations assembled to discuss the transition to an alternative reference rate (ARR).
- Training traders and portfolio managers on new policies and procedures related to the ARR transition.
- Assessing their internal systems from an operational standpoint to ensure functioning after the adoption of an ARR, including corresponding with service providers, subadvisers and third-party managers to similarly assess their preparedness.
- For advisers facing indirect client exposure, sending related third parties due diligence questionnaires regarding their transition preparedness. The Division recommended that advisers with more direct client exposure should focus on remediating LIBOR-linked contracts whenever practicable.
- Considering the impact of a LIBOR transition on their contracts, as well as those of subsidiaries and affiliates, and reevaluating their contracts' fallback provisions. The Division indicated that firms should focus on identifying and assessing the provisions that pose the greatest threat of operational challenges during the transition (*e.g.*, third-party discretion, extensive amendment processes, hardwired fallbacks), and categorizing investments according to the level of risk assumed in the fallback provisions in order to simplify portfolio managers' review and purchasing decisions.
- Considering new trading restrictions for LIBOR-linked instruments.
- Considering the conflicts of interest that could arise in the transition, such as "cross-trading, principal transactions, allocation of transition costs, and clients with conflicting priorities."[10] The Division advised that firms should consistently disclose any legal, operational, credit and regulatory risks involved; communicate directly with clients who have the greatest exposure to LIBOR impacts; and continue to share information with less-exposed clients through fund documents and online materials.

For additional detail on firms' practices in preparation for the LIBOR transition, see the SEC's May 2023 risk alert, "Observations From Examinations of Investment Advisers and Investment Companies Concerning LIBOR-Transition Preparedness."

[10] SEC, "Observations From Examinations of Investment Advisers and Investment Companies Concerning LIBOR-Transition Preparedness" (May 11, 2023).

Amendments to Buyback Disclosure Rules Applicable to BDCs and Listed Closed-End Funds

On May 3, 2023, the SEC adopted amendments to its existing rules regarding disclosures about purchases of an issuer's equity securities by or on behalf of the issuer or an affiliated purchaser ("buybacks"). The amended rules will impact business developments companies (BDCs) and exchange-traded registered closed-end management investment companies (Listed Closed-End Funds). The amendments do not apply to nontraded registered closed-end funds and registered open-end funds.

Disclosure of Daily Share Repurchase Activity

In lieu of the current requirement to disclose monthly repurchase data in an issuer's periodic reports, the amendments require BDCs and Listed Closed-End Funds to include tabular disclosure of their share repurchase activity aggregated on a daily basis in quarterly reports for BDCs or semiannual reports for Listed Closed-End Funds. The table must include, for each date on which a share repurchase is executed:

- The class of shares.
- The total number of shares purchased.
- The average price paid per share.
- The total number of shares purchased as part of a publicly announced program.
- The aggregate maximum number of shares (or approximate dollar value) that may yet be purchased under the publicly announced program.
- The total number of shares purchased on the open market (excluding tender offers and exercised put options).
- The total number of purchased shares intended to qualify for the Rule 10b-18 safe harbor.
- The total number of shares purchased pursuant to a Rule 10b5-1 plan.

Issuers must also indicate whether certain officers and directors purchased or sold shares that are subject to a share repurchase program within four business days before or after the announcement of the program.

Enhanced Narrative Disclosure Requirements

The amendments also expand the requirements for narrative disclosures of share repurchases. BDCs and Listed Closed-End Funds will be required to make narrative disclosures regarding:

- The objectives or rationales for the issuer's share repurchases and the process or criteria used to determine the amount of repurchases.
- Any policies and procedures relating to purchases and sales of the issuer's securities during a repurchase program by its officers and directors, including any restrictions on such transactions.

Regarding the narrative disclosure now required regarding the objectives or rationales for the issuer's share repurchases and the process or criteria used to determine the amount of repurchases, the SEC's release adopting these amendments provides additional guidance. The SEC states, "Although the disclosures required by the final amendments should convey a thorough understanding of the issuer's objectives or rationales for the repurchases, and the process or criteria it used in determining the amount of the repurchase, the final amendments do not require issuers to provide disclosure at a level of granularity that would reveal any competitive or sensitive information beyond what may already be gleaned from other disclosures regarding the business and financial condition of the issuer."

The SEC also describes various topics that issuers may wish to discuss in response to this requirement, including:

i. Other possible ways to use the funds allocated for the repurchase and a comparison of the repurchase with other investment opportunities that would ordinarily be considered by the issuer, such as capital expenditures and other uses of capital.

ii. The expected impact of the repurchases on the value of remaining shares.

iii. The factors driving the repurchase, including whether the stock is undervalued, prospective internal growth opportunities are economically viable or the valuation for potential targets is attractive.

iv. The sources of funding for the repurchase, where material, for example, in the case where a source of funding results in tax advantages that would not otherwise be available for a repurchase.

Disclosure Regarding Rule 10b5-1 Trading Arrangements

The amendments will require BDCs and Listed Closed-End Funds to disclose whether they adopted or terminated a rule 10b5-1 plan during their most recently completed fiscal year. Such disclosure must include a description of the material terms of the plan, including the date on which the rule 10b5-1 plan was adopted or terminated, the duration of the 10b5-1 plan and the aggregate number of securities to be purchased or sold pursuant to the 10b5-1 plan.

Compliance Dates

BDCs must comply with the amendments to reports on Forms 10-Q and 10-K, beginning with the first filing that covers the first full fiscal quarter that begins on or after October 1, 2023. Listed Closed-End Funds must comply with the amendments beginning with the annual or semiannual report on Form N-CSR that covers the first six-month period that begins on or after January 1, 2024.

Notably, a number of industry groups have sued the SEC to block implementation of the newly adopted amendments, which could impact the amendments' effective dates.

For additional information on the rule amendments, see our May 5, 2023, client alert "SEC Adopts New Share Repurchase Disclosure Requirements."

SEC Staff's Latest Risk Alert Highlights Additional Focus Areas for Compliance With the Advisers Act Marketing Rule

On June 8, 2023, the SEC's Division of Examinations issued a risk alert highlighting certain additional areas of emphasis for upcoming examinations, including the new investment adviser marketing rule, Rule 206(4)-1 under the Investment Advisers Act of 1940 (the Marketing Rule). The SEC's continued focus on the Marketing Rule perhaps portends a focus from the Division of Enforcement as well, given the SEC's recent "regulation by enforcement" approach in various areas.

Continuing Review of the Initial Examination Areas

The latest risk alert noted that the Division's staff (Staff) will continue to focus on areas previously identified in the earlier risk alert published on September 19, 2022, including:

- Evaluating whether advisers have adopted and implemented written policies and procedures that are reasonably designed to prevent violations of the Marketing Rule by the advisers and their supervised persons.
- Evaluating whether advisers have a reasonable basis for believing they will be able to substantiate material statements of fact in their advertisements.
- Evaluating whether advisers are in compliance with performance advertising requirements stipulated by the Marketing Rule.
- Evaluating whether advisers are in compliance with Rule 204-2 of the Advisers Act, which requires advisers to maintain specified records of all advertisements they disseminate, including certain internal working papers, performance-related information and documentation for oral advertisements, testimonials and endorsements.

Continuing Review for Compliance With General Prohibitions

The Staff noted the Division will continue to focus on whether investment advisers have disseminated advertisements that violate any of the following general prohibitions:

- Including an untrue statement or omission of a materials fact, making the statement misleading.
- Including a material statement of fact that the adviser does not have a reasonable basis for believing it will be able to substantiate upon demand by the SEC.
- Including information that would reasonably be likely to cause an untrue or misleading implication or inference to be drawn concerning a material fact relating to the adviser.
- Discussing any potential benefits to clients or investors connected with or resulting from the adviser's services or methods of operation without providing fair and balanced treatment of any associated material risks or limitations.
- Referencing specific investment advice provided by the adviser in a manner that is not fair and balanced.
- Including information that is otherwise materially misleading.

Additional Marketing Rules Areas of Emphasis

The Staff identified other practices subject to scrutiny under the Marketing Rule, including, but not limited to:

- **Testimonials and Endorsements:** The Staff will review whether investment advisers are:
  - Providing disclosures, including clear and prominent disclosure of whether the person giving the testimonial or endorsement is a client or investor, whether the promoter is compensated and if material conflicts of interest exist.

- Meeting oversight conditions, such as whether the advisers have a reasonable belief that the testimonials or endorsements disseminated comply with the requirements of the Marketing Rule.
- Entering into written agreements, where required, such as agreements with promoters.
- Compensating ineligible persons for testimonials or endorsements, if the adviser knew or reasonably should have known a person was ineligible, including "bad actors" that are prohibited from acting as promoters.

- **Third-Party Ratings:** The Staff will review whether:
  - The adviser provides, or reasonably believes that the third-party rating provides, clear and prominent disclosure of (i) the date on which the rating was given and the period of time upon which the rating was based; (ii) the identity of the third party that created and tabulated the rating; and (iii) if applicable, that compensation has been provided directly or indirectly by the adviser in connection with obtaining or using the third-party rating.
  - Questionnaires or surveys used in preparing a third-party rating meet certain conditions, such as the adviser having a reasonable basis for believing that such questionnaire or survey is structured to make it equally easy for a participant to provide favorable and unfavorable responses and is not designed or prepared to produce any predetermined result.
- **Form ADV:** The Staff will review whether advisers accurately completed the new subsection to Item 5 of Form ADV Part 1A regarding the adviser's marketing activities in connection with annually updated amendment filings.

The Staff encourages investment advisers to review and revise their practices, policies and procedures to implement appropriate modifications to their training, supervisory, oversight and compliance programs.

Form PF

On May 3, 2023, the SEC adopted final amendments to Form PF, the confidential reporting form used by certain SEC-registered investment advisers (RIAs) to private funds. The SEC designed the reporting requirements to enhance the Financial Stability Oversight Council's (FSOC's) ability to monitor systemic risk and to bolster the SEC's regulatory oversight of private fund advisers and investor protection efforts.

The amendments, first proposed by the SEC in January 2022, mainly affect RIAs, hedge funds and private equity funds. The changes include the following:

i. New Section 6, which requires quarterly reporting by all private equity fund advisers regarding (a) adviser-led secondary transactions and (b) actions by investors to remove a fund's general partner or terminate a fund or its investment period.

ii. Amendments to Section 4, which require additional reporting from large private equity fund advisers.

iii. New Section 5, which requires current reporting (*i.e.*, as soon as practicable and no later than 72 hours after a reportable event) from large hedge fund advisers.

New Section 6 — Quarterly Event Reporting by All Private Equity Fund Advisers

The new rules require all private equity fund advisers to make quarterly reports on the occurrence of any of the following events within 60 days of the relevant fiscal quarter-end: (i) the completion of an adviser-led secondary transaction; or (ii) investor election to remove a fund's general partner or terminate a fund or its investment period.

i. "Adviser-led secondary transaction" is defined as any transaction initiated by the adviser or any of its related persons that offers private fund investors the choice to (a) sell all or a portion of their interests in the private fund, or (b) convert or exchange all or a portion of their interests in the private fund for interests in another vehicle advised by the adviser or any of its related persons. Specifically, New Section 6 item B of Form PF will require private equity fund advisers to briefly describe the transaction and note its closing date.

ii. Private Equity fund advisers will be required to report when a fund's investors have (with or without cause): (a) removed the adviser or an affiliate as the general partner or similar control person of the fund; (b) elected to terminate the fund's investment period; or (c) elected to terminate the fund.

Amended Section 4 — Additional Reporting by Large Private Equity Fund Advisers

Large private equity fund advisers (*i.e.*, any adviser having at least $2 billion in regulatory assets under management attributable to private equity funds as of the last day of the adviser's most recently completed fiscal year) will now be required to report annually on the following topics: (i) any general partner clawback; or (ii) a limited partner clawback in excess of an aggregate amount equal to 10% of a fund's aggregate capital commitments.

Additionally, other amendments to Section 4 will collect information about:

- Private equity fund strategies (*e.g.*, private credit, private equity, real estate, annuity and life insurance policies, litigation finance, digital assets and general partner stakes investing).
- Fund-level borrowings (including information about each form of financing available to a fund, the total dollar value available and the average amount borrowed during the period).
- Events of default.

- The identities of institutions providing bridge financing to an adviser's controlled portfolio companies and the amount of such financing.
- The geographic breakdown of investments.

New Section 5 — Current Reporting by Large Hedge Fund Advisers

Rather than requiring Form PF reports on a quarterly basis, the addition of new Section 5 creates a near real-time obligation for large hedge fund RIAs (*i.e.*, private fund advisers having at least $1.5 billion in regulatory assets under management attributable to hedge funds) to file a current report upon the occurrence of certain events the SEC believes may indicate significant stress or otherwise serve as signals of potential systemic risk implications. Specifically, the events that must now be reported as soon as practicable, and no later than 72 hours after the occurrence of such event, include:

- Extraordinary investment losses (*i.e.*, any loss equal to or greater than 20% of a fund's "reporting fund aggregate calculated value" (RFCAV) over a rolling 10-day period).
- Significant margin and default events (including increases in a fund's requirements for margin, collateral or an equivalent based on a 20% threshold or a fund's or a counterparty's margin default or inability to meet a call for margin, collateral or an equivalent).
- The termination or material restriction, in whole or in part, of a prime broker relationship.
- Any significant disruption or degradation of the reporting fund's critical operations (*i.e.*, operations necessary for (i) the investment, trading, valuation, reporting and risk management of the reporting fund or (ii) the operation of the reporting fund in accordance with federal securities laws and regulations), whether as a result of an event at a service provider to the reporting fund, its adviser or the fund itself.
- Large withdrawal and redemption requests (*i.e.*, requests exceeding 50% of the most recent net asset value), the inability to satisfy redemption or withdrawals and suspensions of redemptions or withdrawals.

When the SEC adopted Rule 204(b)-1 under the Investment Advisers Act of 1940 (the Advisers Act) in 2011 shortly after the 2008-2009 financial crisis, the SEC's rationale was to provide crucial data to policymakers to help identify systemic trends in the private fund industry and corresponding risks to U.S. financial markets. Now, as rationale for the latest amendments, the SEC highlighted the growth of private funds, noting that private fund assets have nearly tripled in the last decade from $5 trillion in 2013, when Form PF went into effect, to nearly $14 trillion in 2022.

Private fund advisers should review and revise their reporting and monitoring procedures and practices to ensure they account for the new reporting requirements.

The SEC's final rule is effective June 11, 2024, except for new Sections 5 and 6, which are effective December 11, 2023.

Updated Guidance on Regulation Best Interest

On April 20, 2023, the SEC staff released a bulletin on the standards of conduct for broker-dealers and investment advisers, established under Regulation Best Interest (Reg BI) and the Investment Advisers Act of 1940. The guidance expands previous Reg BI requirements in three key regards:

- Firms should exercise increased scrutiny when broker-dealers recommend complex products to retail consumers, regardless of whether the products are high-risk.
- Firms should adopt a process for evaluating alternatives to complex and risky products. The process should define (i) the scope of alternatives to consider and (ii) decision-making factors, such as costs and benefits, risks and overall compatibility with the retail investor's investment profile. Firms should provide guidance on this process to professionals in the form of updated policies and procedures and additional employee training.
- Firms that recommend complex or risky products should consider developing stricter due diligence procedures to ensure the involvement of "qualified and experienced firm personnel."[11]

For a full discussion of the updated Reg BI guidance, see our May 1, 2023, client alert "SEC Staff Raises the Bar for Broker-Dealers Under Regulation Best Interest."

[11] SEC, *Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Care Obligations* (last updated April 20, 2023).

Accredited Investor Eligibility Expansion

On May 31, 2023, and June 5, 2023, the United Stated House of Representatives passed two bills that would expand the definition of accredited investor, thereby expanding the pool of individuals deemed eligible to invest in private unregistered securities.

The first bill would grant the SEC discretion to determine what professional credentials, certifications or designations an investor must possess to be considered an accredited investor. The bill also provides that the SEC must review these credentials every five years.

The second bill would require the SEC to establish an exam for individual investors seeking to attain accredited investor status. The exam would be administered by the Financial Industry Regulatory Authority (FINRA) and would be designed with an appropriate difficulty level such that an individual with financial sophistication or training would be unlikely to fail.

Currently, the accredited investor qualification is determined mostly (i) by income and wealth, such as having an annual income over $200,000 individually or $300,000 with a spouse or partner, or a net worth of more than $1 million; or (ii) by professional criteria, such as being an investment professional in good standing who holds certain licenses.

Each bill has been sent to the Senate for review.

Regulatory Agenda Highlights

On June 13, 2023, the U.S. Office of Information and Regulatory Affairs released the SEC's Spring Regulatory Agenda, which includes over 50 proposed regulations on a range of social, economic and investor protection topics.

Final stage rules address, among other topics:

- Climate change disclosure for issuers and investment advisers.
- Safeguarding investment advisory client assets.
- Restrictions on special purpose acquisition companies (SPACs).
- Money market and mutual fund "swing pricing."
- Private fund adviser reporting, disclosure and compliance documentation.
- Short sales, securities lending and beneficial ownership disclosures.
- Amendments to revise the definition of "dealer" and require more firms engaged in trading activity to join FINRA.

Rules at the proposal stage address, among other topics:

- Disclosure on management of human capital.
- Board diversity.
- The use of artificial intelligence and similar technologies by investment advisers and broker-dealers in connection with investor interactions.
- Fund fees and fee disclosure reforms.
- Regulation D and Form D amendments.
- Increased transparency in national security exchanges' volume-based transaction pricing in National Market System stocks.

The SEC at the end of July adopted new cybersecurity regulations (which we discussed in April 2023) to complete one of the goals of the agency's spring agenda.

SEC's Cryptoasset Enforcement Actions

The SEC continues to aggressively pursue enforcement actions in the crypto space, asserting that cryptoassets and digital assets are securities and that companies operating in the crypto space without registering with the SEC are operating unregistered intermediaries for securities and engaging in unregistered offers and sales of securities.

In a speech on June 8, 2023, SEC Chair Gary Gensler reiterated his view that "the vast majority of crypto tokens meet the investment contract test." If a cryptoasset is identified as a security, the next question is what the relevant trading platform should do to comply with the existing regulatory framework. The SEC's attitude is straightforward: The crypto platforms should register with the SEC or satisfy requirements for an exemption. However, compliance may be more complicated for crypto platforms than it is for their peers in traditional securities markets. For example, the SEC's expectations for platforms serving multiple intermediation functions may require significant changes to a platform's business. As emphasized in the SEC's recent enforcement activity, exchange, broker-dealer and clearing functions are typically separated in traditional securities markets. Chair Gensler warned that crypto intermediaries might need to separate their lines of business to comply with these requirements. This may add additional complexities and costs that platforms need to consider when deciding how to transform their business for compliance if and when it is ultimately determined that certain crypto tokens and digital assets are securities.

In addition to its broad interpretation of "securities," the SEC has explored other angles to bring more crypto systems into the purview of the existing regulatory framework. The SEC's release on April 14, 2023 (Reopening Release) announced the reopening of the comment period for proposed amendments to the Securities Exchange Act of 1934 Rule 3b-16 to expand the definition of an "exchange." Chair Gensler stated that many crypto trading platforms were already covered by the current definition and thus must comply with the securities laws. The Reopening Release also provided information for systems that would be included in the new definition.

In the absence of congressional actions to provide clear guidance, the SEC's enforcement actions may shape the crypto regulatory framework. In the varied actions the SEC has brought, the SEC includes nonexhaustive lists of certain assets that it claims are securities. Through its enforcement actions, the SEC has taken public positions on whether particular cryptoassets or digital assets are "securities." The list of disfavored assets may grow with the SEC's further actions. Notably, U.S. courts have not yet established definitive case law on this subject, and they may not agree with the SEC's position regarding particular cryptoassets. Furthermore, Congress may seek to provide a statutory framework for digital assets separate from the existing traditional securities framework. For example, a bipartisan bill reintroduced in May 2023 aimed to clarify that an underlying asset (e.g., a crypto token) sold pursuant to an investment contract does not become a security merely as a result of its being sold under an investment contract. Crypto platforms, however, should be vigilant about the assets they permit to trade given that the SEC only needs to find that one cryptoasset transacted on an unregistered platform is a security to assert the SEC's enforcement authority.

Takeaways

The SEC's intention to subject cryptoassets and crypto trading platforms to the existing securities regulatory framework is apparent. Crypto trading platforms should frequently review the assets they trade, the services they provide, their corporate governance and market surveillance on the platforms to assess regulatory and compliance risks. In the absence of clear legislative guidance and case law at this moment, crypto platforms, when making operational decisions, may wish to consider the stricter scrutiny that may apply to them under the SEC's present enforcement strategy and continuously monitor for developments and changes in the regulatory framework.