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Investment Management Update

November 2020

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In This Update

Covering legal developments and regulatory news for funds, their advisers, and industry participants through October of 2020.

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Rulemaking and Guidance

SEC Proposes Finders Exemption

10.08.20

At the October 7 open meeting of the Securities and Exchange Commission (SEC or Commission), Chairman Jay Clayton announced that the staff of the Commission proposed to grant exemptive relief, permitting natural persons to engage in certain limited activities for issuers (Finders), without registering as brokers under Section 15 of the Exchange Act.

The proposed exemption designates two new classes of Finders: Tier I and Tier II. Those that narrow their activities to align with the proposal can avoid registering as a registered representative of a broker-dealer and still receive transaction-based compensation. See text of the proposed order. The staff also prepared a concise chart that compares Tier I Finders, Tier II Finders, and traditional broker-dealers, covering permitted/nonpermitted activities, as well as payment options and by whom.

First, only natural persons can be Finders under the proposed order; a Finder's LLC or other company is not eligible. That makes sense because the SEC views a broker-dealer license as unique to the entity and considers the persons who generate the activity and profits as its registered representatives.

Second, the Finder must know or have a reasonable belief that the person being solicited is an accredited investor. The proposal requires the Finder to follow traditional paths to form that reasonable belief before undertaking a solicitation.

Third, the proposal shows the Commission's recognition that accredited investors provide the lion's share of growth capital for small businesses in the modern capital markets, and small businesses often find it difficult without the help of a Finder to reach those accredited investors.

The proposed exemption for Tier I and Tier II Finders are available only where:[1]

- The issuer is not required to file reports under Section 13 or Section 15(d) of the Exchange Act (*e.g.,* the issuer is a private, nonreporting company);
- The issuer aims to conduct the securities offering relying on an applicable exemption from registration under the Securities Act (any offering exempt under the Securities Act of 1933 should be eligible, including those conducted under Section 4(a)(2) of the Securities Act, as well as those under the Regulation D safe-harbor; Regulation A and Regulation A+ offerings entail some form of general solicitation, and Regulation CF offerings require a registered crowd funding portal, making them ineligible under this proposed exemptive order);
- The Finder does not engage in general solicitation (which implicitly means that the Finder cannot participate in a JOBS Act Rule 506(c) offering of the issuer since that would involve a general solicitation);
- The potential investor is an "accredited investor" as defined in Rule 501 of Regulation D, or the Finder has a reasonable belief that the potential investor is an "accredited investor";
- The Finder provides services under a written agreement with the issuer that includes a description of the services provided and associated compensation (in this regard, the Finders under the proposal would look a lot like a "third-party solicitor" under the Investment Advisers Act of 1940);
- The Finder is not an associated person of a broker-dealer (if the Finder is an associated person of a broker, then the associated person status controls, and he/she cannot "sell away" as a Finder); and

- The Finder is not subject to statutory disqualification, as defined in Section 3(a)(39) of the Exchange Act, at the time of his/her participation.

Tier I Finders. For purposes of the proposed exemption, a "Tier I Finder" is a Finder who meets the above conditions and whose activity is limited to providing contact information of potential investors with only one capital raising transaction by a single issuer within a 12-month period, provided the Tier I Finder does not have any contact with the potential investors about the issuer. The contact information may include, among other things, name, telephone number, email address, and social media information. The Commission preliminarily believes limiting the exemption to this activity will appropriately narrow the Tier I Finder's role to preclude the participation in continuous or multiple sales of securities by persons not subject to broker-dealer registration or to the heightened requirements of Tier II Finders. A Tier I Finder who complies with all of the exemption's conditions may receive transaction-based compensation for the limited services described above without being required to register as a broker under Section 15(a) of the Exchange Act.[2]

This is effectively a codification of the *Paul Anka* no-action letter (1991 SEC No-Act Lexis 925 (July 24, 1991)).

Tier II Finders. The Commission also proposes an exemption, permitting a Finder — if meeting certain conditions — to engage in additional solicitation-related activities beyond those permitted for Tier I Finders. For purposes of the proposed exemption, a "Tier II Finder" is a Finder who meets the above conditions, and who engages in solicitation-related activities for an issuer that are limited to: (1) identifying, screening, and contacting potential investors; (2) distributing issuer offering materials to investors; (3) discussing issuer information included in any offering materials, provided that the Tier II Finder does not provide advice about the valuation or advisability of the investment; and (4) arranging or participating in meetings with the issuer and investor. As discussed above, the Commission generally views solicitation as any affirmative effort to induce or attempt to induce a securities transaction and broadly views these activities of Tier II Finders to constitute solicitation.[3]

Under the proposal, so-called Tier II Finders could identify, screen, and contact potential investors; distribute issuer offering materials to investors; discuss issuer information included in offering materials; arrange or participate in meetings with the issuer and the investor; and participate in more than one capital raising transaction within a 12-month period. Tier I Finders may not engage in any of these activities (the last one is the most telling as it would effectively preclude someone from "being in the business" of being a Tier I Finder).

So How Does One Become a Tier II Finder?

While the proposal requires a written agreement for all Finders, Tier II Finders must satisfy certain additional written disclosure obligations. First, the Tier II Finder would need to provide a potential investor, prior to or at the time of the solicitation, disclosures that include: (1) the name of the Tier II Finder; (2) the name of the issuer; (3) the description of the relationship between the Tier II Finder and the issuer, including any affiliation; (4) a statement that the issuer will compensate the Tier II Finder for his/her solicitation activities and a description of the compensation arrangement terms; (5) any material conflicts of interest resulting from the arrangement or relationship between the Tier II Finder and the issuer; and (6) an affirmative statement that the Tier II Finder is acting as an agent of the issuer, is not acting as an associated person of a broker-dealer, and is not undertaking a role to act in the investor's best interest.

This disclosure can be provided orally under the proposal, so long as written disclosure will follow soon after and before the investment in the issuer's securities.

Also, the Tier II Finder must obtain an acknowledgement (on paper or electronically) from the investor that the investor has received the necessary disclosure. It is this disclosure and acknowledgement process that

looks very much like the cash solicitation rule for third-party solicitors under the Investment Advisers Act of 1940 Rule 206(4)-3; however, the staff noted certain differences between the two regulatory regimes.

Practice Points

Before the reader burns his/her membership agreement with FINRA or sponsoring broker-dealer contract, a few observations are in order:

This is a proposed exemptive order, not a statutory change. It is not yet effective, subject to a comment period, and then subject to a vote by the full Commission. Over the years, many similar proposals have been offered with very significant industry advocates backing — but to no avail. This time, it is a staff proposal, which probably gives it an inside track. However, with the pending election, it is unlikely that this will be acted upon until January, especially if there is a change in Congress or the administration. So while promising, it remains just a proposal at this juncture. Further, if an order is issued, the final order may be substantially different than the proposed order.

Second, it is designed, if adopted, as a "nonexclusive safe harbor" — meaning if you don't fit within the proposed exemption, you can still rely on current law if it covers your situation.

Third, if adopted, associated persons of a registered broker-dealer cannot become Finders and obtain compensation outside of the broker-dealer structure — in other words, if you are a registered representative of a broker, the selling away prohibitions are alive and well.

Fourth, if adopted, the proposal would eliminate the federal "Section 15 Sword of Damocles" remedy — also known as rescission — regarding those transactions, where an illegal Finder received transaction-based compensation under current law, which subjects the entire raise to a "rescission" risk under current law. State law — such as the New York Statute of Frauds that makes a broker's claim for selling compensation illegal and unenforceable if not in writing, as well as California's and Florida's rights of rescission — would still apply. Moreover, Finders wanting to engage in activities beyond the scope of the proposed exemptive order would still need to become associated persons of a broker-dealer in order to legitimately receive transaction-based compensation.

While definitely a step in the right direction, the proposal still has a long road ahead of it. In the meantime, please continue to apply the rules as currently written and interpreted.

A copy of the SEC's Finders Proposed Exemptive Order can be found at https://www.sec.gov/rules/exorders/2020/34-90112.pdf.

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New SEC Rule Codifies Fund-of-Funds Relief

10.07.20

In welcome news for the investment management industry, the SEC adopted a new rule and comprehensive amendments to existing rules to make it easier for registered investment funds to invest in securities of other registered fund products (*i.e.*, fund-of-funds arrangements). On October 7, the SEC unanimously voted to adopt new Rule 12d1-4 under the 1940 Act to repeal existing Rule 12d1-2 and to amend Rule 12d1-1. The SEC also adopted changes to Form N-CEN and recordkeeping requirements related to fund-of-funds arrangements.

The rule changes are designed to make it easier for funds to acquire significant shares of other funds without obtaining individualized exemptive relief.[1] In addition, the SEC stated in its adopting release that "the scope of permissible acquiring and acquired funds under Rule 12d1-4 is greater than the scope of funds that was permitted by the Commission's exemptive orders."[2] The changes should result in a framework that provides more flexibility and transparency to funds seeking to enter into fund-of-funds arrangements, while reducing the burden and expense of undertaking individualized exemptive applications in most situations.

The SEC's October 7 rulemaking follows a proposal it released on December 19, 2018.[3] The October 7 adopting release extensively discusses the comments the SEC received in response to the 2018 proposal, and the final rule includes significant changes from the proposed rule.

Context and Background

Section 12(d)(1)(A) of the 1940 Act contains limits on a registered fund's ability to invest in other registered funds. These limits are commonly referred to as the "3-5-10%" limits, because they restrict a registered fund's ability to acquire securities of another registered fund to these levels, depending on the circumstances.[4] Section 12(d)(1)(B) places similar limits on an open-end fund's ability to sell its securities to other registered investment companies, while Section 12(d)(1)(C) addresses limitations on fund investments in registered closed-end funds. Prior to the enactment of Rule 12d1-4, funds wishing to enter into fund-of-funds arrangements outside of these limitations generally had to obtain individualized exemptive relief or comply with a narrow set of exceptions delineated in Rule 12d1-2, now rescinded.

New Rule 12d1-4

Under new Rule 12d1-4, a registered fund will now be permitted to invest in another registered fund or business development company in excess of the statutory limits on fund-of-funds arrangements codified in

[1] Because the amendments provide a comprehensive exemption for fund-of-funds arrangements that previously required exemptive relief, the SEC voted to repeal most currently existing exemptive orders permitting such fund-of-funds arrangements.

[2] https://www.sec.gov/rules/final/2020/33-10871.pdf. The press release accompanying the adopting release is located at https://www.sec.gov/news/press-release/2020-247.

[3] The SEC's proposing release from 2018 is located at https://www.sec.gov/rules/proposed/2018/33-10590.pdf.

[4] Section 12(d)(1)(A) of the 1940 Act generally provides that it is unlawful for any registered fund (the "acquiring company") and any company or companies controlled by such acquiring company to purchase or otherwise acquire any security issued by any other investment company (the "acquired company"), and for any investment company (the "acquiring company") and any company or companies controlled by such acquiring company to purchase or otherwise acquire any security issued by any registered investment company (the "acquired company"), if the acquiring company and any company or companies controlled by it immediately after such purchase or acquisition own in the aggregate: (i) more than 3% of the total outstanding voting stock of the acquired company; (ii) securities issued by the acquired company having an aggregate value in excess of 5% per centum of the value of the total assets of the acquiring company; or (iii) securities issued by the acquired company and all other investment companies having an aggregate value in excess of 10% of the value of the total assets of the acquiring company.

Section 12(d)(1) of the 1940 Act, without obtaining an individualized exemptive order. Funds relying on Rule 12d1-4 must comply with specific conditions set forth in the rule, as summarized below:

- *Limits on Control*. The rule generally prohibits an acquiring fund and its advisory group from controlling another fund subject to limited exceptions.[5] In general, this means that even in reliance on Rule 12d1-4, an acquiring fund and its advisory group[6] cannot purchase more than 25% of the voting securities of an acquired fund because the 1940 Act creates a rebuttable presumption that any person who beneficially owns more than 25% of the securities of a company controls that company.[7]
- The rule also places voting limitations on funds that own more than 25% of the securities of an acquired open-end fund or unit investment trust as a result of a decrease in the outstanding securities of the acquired fund or more than 10% of a closed-end fund or BDC. In such circumstances, the acquiring fund would be required to "mirror vote" its shares on any shareholder questions. Mirror voting means the fund must vote its shares proportionally to the results of the overall vote.
- *Required Evaluations and Findings*. In order to prevent acquiring funds from exerting undue influence on an acquired fund, such as by charging duplicative fees and expenses, the new rule requires advisers to acquiring and acquired funds to make certain findings regarding the fund-of-funds arrangement, after considering specific factors enumerated by Rule 12d1-4. The new rule also requires an acquiring fund's adviser, principal underwriter, or depositor to conduct an evaluation of the complexity of the fund-of-funds structure, its aggregate fees, and make a specific finding that the fees and expenses are not duplicative. The factors and required findings enumerated in the rule differ depending on whether a fund is the acquiring or acquired fund and whether it is a management company, unit investment trust, or a separate account funding variable insurance contracts.
- *Fund-of-Funds Investment Agreements.* Funds that intend to enter into fund-of-funds arrangements in excess of Section 12(d)(1)'s limits and in reliance on Rule 12d1-4 must enter into an agreement memorializing the terms of the fund-of-funds arrangement prior to the acquiring fund's acquisition of the acquired fund's securities. Among other things, the agreement must memorialize the terms that serve as the basis for the required evaluations and findings described above. The new rule exempts funds that share the same investment adviser from this requirement to enter into such an agreement.
- *Limits on Complex Structures*. The new rule generally prohibits three-tier fund-of-funds arrangements, although it enumerates certain specific exceptions.[8] An important exception permits an acquired fund to invest up to 10% of its total assets in other funds, including private funds, without restriction.
- *Recordkeeping Requirements.* Funds that participate in fund-of-funds arrangements in reliance on Rule 12d1-4 must maintain and preserve written records, including (i) a copy of each fund-of-funds

[5] Exceptions include situations where (i) the acquiring fund is within the same group of investment companies as an acquired fund, or (ii) the acquiring fund's investment sub-adviser or any person controlling, controlled by, or under common control with such investment sub-adviser acts as the acquired fund's investment adviser or depositor.

[6] Rule 12d1-4(d) defines "advisory group" to mean "either (1) an acquiring fund's investment adviser or depositor, and any person controlling, controlled by, or under common control with such investment adviser or depositor, or (2) an acquiring fund's investment sub-adviser and any person controlling, controlled by, or under common control with such investment sub-adviser."

[7] A determination of control is not based solely on percentage ownership of securities, but also includes a facts and circumstances analysis. Funds and their advisory groups that own less than 25% of another fund's shares can still be deemed to control the fund, which generally is prohibited under Section 12(d) of the 1940 Act and Rule 12d1-4 subject to limited exceptions.

[8] These exceptions include circumstances where an acquired fund may invest in another fund to efficiently manage uninvested cash to address specific regulatory or tax limitations or to facilitate certain transactions. Specifically, these categories include securities of another investment company that are: (i) acquired in reliance on Section 12(d)(1)(E) of the 1940 Act (*i.e.,* master-feeder arrangements); (ii) acquired pursuant to Rule 12d1-1; (iii) a subsidiary wholly owned and controlled by the acquired fund; (iv) received as a dividend or as a result of a plan of reorganization of a company; or (v) acquired pursuant to exemptive relief from the SEC to engage in interfund borrowing and lending transactions.

investment agreement currently in effect, or was in effect in the past five years, and any amendments thereto; (ii) a written record of the relevant Fund Finding made under the rule and the basis therefor within the past five years; and (iii) the certification from each insurance company required by the rule. These records must be kept for no less than five years, and they must be kept in an "easily accessible place" for the first two years.

Additional Amendments and Regulatory Action

In addition to adopting Rule 12d1-4, the SEC also adopted certain related amendments on October 7. These amendments work in tandem with Rule 12d1-4 to create a comprehensive framework for fund-of-funds arrangements that does not require individualized exemptive relief in most circumstances. These additional amendments include the following:

Rescission of Rule 12d1-2 and Amendment to Rule 12d1-1

The SEC voted to rescind Rule 12d1-2 in its entirety. Rule 12d1-2 permitted certain limited fund-of-funds arrangements beyond the scope of Section 12(d)(1)(G) of the 1940 Act. These situations included permitting a fund to (i) acquire the securities of other funds that are not part of the same group of investment companies, subject to the limits in Section 12(d)(1)(A) or 12(d)(1)(F); (ii) invest directly in stocks, bonds, and other securities; and (iii) acquire the securities of money market funds in reliance on Rule 12d1-1. In addition to the rescission of Rule 12d1-2, the SEC voted to rescind its exemptive orders permitting fund-of-funds arrangements that fall within the scope of Rule 12d1-4, with certain limited exceptions. As a result, funds now wishing to enter into a fund-of-funds situation must generally comply with Rule 12d1-4 and its restrictions.

The SEC also amended Rule 12d1-1. The amended rule allows funds to invest in money market funds outside the same group of investment companies, notwithstanding the rescission of Rule 12d1-2.

Amendments to Form N-CEN to Facilitate Disclosure of Fund-of-Funds Arrangements

In addition to the changes discussed above, the SEC voted to amend Form N-CEN. The amendments require funds that participate in a fund-of-funds arrangement to disclose whether they rely on Rule 12d1-4 or the statutory exception in Section 12(d)(1)(G) of the 1940 Act during each applicable reporting period.

Next Steps, Effective Date, Takeaways

The new Rule 12d1-4 and related amendments become effective 60 days after publication in the Federal Register. The changes to Form N-CEN will go into effect 425 days after publication in the Federal Register.

Rule 12d1-4 and related amendments should make it easier for registered funds to enter into fund-of-funds arrangements. As noted above and in the adopting release, the rule expands the scope and degree of permissible fund-of-funds arrangements, and it streamlines the process by eliminating the need to obtain an exemptive order in most situations. The elimination of exemptive applications in the fund-of-funds context is part of a trend at the SEC. Recently, the SEC eliminated the need for routine exemptive applications to permit the launch and operation of Exchange Traded Funds in a new rule adopted on September 26, 2019. By eliminating the need to obtain exemptive orders in most fund-of-funds situations, the SEC is taking steps to free resources at the SEC, as well as at funds and advisers, to focus exemptive applications on novel products or arrangements.

Notably private funds and unregistered investment companies (such as foreign funds) cannot rely on new Rule 12d1-4, and so must remain within the limits of Section 12(d)(1) (*i.e.*, may acquire no more than 3% of the securities of a registered fund) or seek individualized exemptive relief to exceed those limits. The SEC's adopting release noted that historically few private or foreign funds have sought to exceed the limits of

Section 12(d)(1). The SEC admitted in the adopting release that it does "not have sufficient experience tailoring conditions for private funds' and unregistered investment companies' investments in registered funds" to include them in a "rule of general applicability." Accordingly, private or unregistered funds seeking exemptive orders for fund-of-funds arrangements should understand the SEC's desire to "weigh policy considerations" and tailor the scope of permissible fund-of-funds arrangements in this context.

The SEC's final rule is available at https://www.sec.gov/rules/final/2020/33-10871.pdf.

SEC's New "Accredited Investor" and "QIB" Definitions May Expand Potential Private Fund Investor Pool

09.03.20

In light of recent amendments adopted by the SEC, the pool of potential investors for private fund managers ***may be expanding***. As noted in a previous advisory, on August 26, the SEC modified its definitions under the Securities Act of 1933 for "accredited investors" in Regulation D Rule 501(a) and "qualified institutional buyers" (QIBs) in Rule 144A (press release). Despite the SEC's efforts to make the private offering exemptions more accessible, many private funds are subject to additional requirements imposing higher eligibility standards that must be complied with to maintain their regulatory status. Accordingly, while certain new categories of accredited investors and QIBs will be a welcome change for private fund managers, some of the other new categories may not actually increase their potential pool of otherwise eligible investors.

The modified definitions for accredited investors and QIBs do not take effect until 60 days after publication in the Federal Register, which has yet to occur. Private fund managers should use the pre-effective period to review and update their fund offering documents, as well as their related policies and procedures. **However, all solicitations and offerings — not just sales — conducted before the effective date must comply with the rules and definitions currently in effect.**

New Categories of Accredited Investors

The SEC added the following new categories of accredited investors:

- Natural persons qualifying based on certain professional certifications, designations, or credentials, (and, by a separate order of the SEC, initially includes holders in good standing of the Series 7, Series 65, and Series 82 licenses), which remains subject to further evaluation, adjustments, and additions by the SEC;
- Private fund "knowledgeable employees,"[1] as defined under Rule 3c-5(a)(4) of the Investment Company Act of 1940, ***with regard to that private fund's securities***;
- Limited liability companies (LLCs) with $5 million in assets;
- SEC and state-registered investment advisers, exempt reporting advisers, and rural business investment companies (RBICs);
- Entities, including Indian tribes, governmental bodies, funds, and entities organized under the laws of foreign countries, that own "investments,"[2] as defined in Rule 2a51-1(b) under the Investment Company Act in excess of $5 million that were not formed for the specific purpose of investing in the securities offered;
- "Family offices"[3] with at least $5 million in assets under management and their "family clients,"[4] each as defined under the Investment Advisers Act of 1940; and
- "Spousal equivalent," permitting spousal equivalents to pool their finances for the purpose of qualifying under the original income test.

Expanded Definition of QIBs

The SEC modified the definition of "qualified institutional buyer" to include the following:

- Institutional investors that qualify under the "accredited investor" definition that are not otherwise covered in the definition of QIB, so long as the $100 million threshold is satisfied; and
- LLCs and RBICs that meet the $100 million in securities owned and invested threshold.

Be Cautious of Additional Private Fund Eligibility Requirements

Not all investors qualifying under the new categories of accredited investor will ultimately be eligible to invest in private funds. In addition to eligibility requirements — such as meeting minimum investment amounts, residency requirements, and certain tax status — private funds may have additional eligibility requirements to meet the conditions of certain regulatory exemptions under the Investment Advisers Act and the Investment Company Act. Under Section 205(a)(1) of the Investment Advisers Act, registered private fund managers are prohibited from charging investors performance-based compensation (*i.e.*, carried interest, performance fees, incentive allocations) unless the investors are "qualified clients" as provided under Advisers Act Rule 205-3's exemption from the compensation prohibition.[5] Private funds relying on Investment Company Act Section 3(c)(7)'s exclusion from the definition of an investment company to avoid registration requirements generally must limit their investors to only those who are "qualified purchasers" as defined in Investment Company Act Section 2(a)(51).[6] Both the qualified client and qualified purchaser standards are generally harder to satisfy than the Securities Act accredited investor standard, narrowing the pool of prospective investors.[7]

The expanded definitions of accredited investor and QIB do provide welcome relief for certain private fund manager employees who satisfied the Investment Advisers Act Rule 205-3 exemption and Investment Company Act Section 3(c)(7) exclusion requirements by virtue of being "knowledgeable employees" under those standards, but were otherwise precluded from investing because of the current accredited investor standard. In particular, adding the new accredited investor category of "knowledgeable employees" harmonizes the SEC's position that such employees, through their knowledge and active participation in the investment activities of the private fund, are likely to be financially sophisticated and capable of fending for themselves and therefore should be eligible to participate in investment opportunities that do not have the additional protections afforded under these securities laws.

Similarly, the expanded definition of QIBs may provide relief for certain private fund investors looking to satisfy not only QIB requirements, but also the qualified purchaser requirement as the definition of qualified purchaser includes certain QIBs.

Compliance Takeaways

During the pre-effective period, private fund managers should consider the following actions:

- Review and update, as applicable, private fund organizational and offering documents, including subscription documents and investor questionnaires to be used upon the effective date;
- Update private offering compliance policies and procedures;
- Provide training to business development and marketing personnel to ensure familiarity with the revised definitions and that the new policies and procedures are implemented properly; and
- For those private funds conducting Securities Act Regulation D Rule 506(c) offerings (*e.g.*, those private offerings with certain permitted general solicitation and advertising), confirm sufficient methods for verifying accredited investor status will be in place upon the effective date, whether verifications are conducted internally or through a third-party vendor. For example, according to the amended definitions' adopting release, firms may use FINRA's BrokerCheck or the SEC's Investment Adviser Public Disclosure database to verify whether prospective investors are eligible accredited investors based on their status as registered representatives and investment adviser representatives.

For more information regarding the amended accredited investor and QIB definitions, please see our August 27 client advisory.

[1] Rule 3c-5(a)(4) under the Investment Company Act defines a "knowledgeable employee" with respect to a private fund as: (i) an executive officer, director, trustee, general partner, advisory board member, or person serving in a similar capacity, of the private fund or an affiliated management person (as defined in Rule 3c-5(a)(1)) of the private fund; and (ii) an employee of the private fund or an affiliated management person of the private fund (other than an employee performing solely clerical, secretarial or administrative functions with regard to such company or its investments) who, in connection with his or her regular functions or duties, participates in the investment activities of such private fund, other private funds, or investment companies the investment activities of which are managed by such affiliated management person of the private fund, provided that such employee has been performing such functions and duties for or on behalf of the private fund or the affiliated management person of the private fund, or substantially similar functions or duties for or on behalf of another company for at least 12 months.

[2] The term "investments" for this purpose generally means: (1) securities (as defined by Section 2(a)(1) of the Securities Act, other than securities of an issuer that controls, is controlled by, or is under common control with, the prospective investors that owns such securities, unless the issuer of such securities is: (i) an investment vehicle (as defined under Investment Company Act Rule 2a51-1(b)); (ii) a public company (as defined under Investment Company Act Rule 2a51-1(b)); or (iii) a company with shareholders' equity of not less than $50 million (determined in accordance with generally accepted accounting principles) as reflected on the company's most recent financial statements, provided that such financial statements present the information as of a date within 16 months preceding the date on which the prospective investor acquires the securities of a Section 3(c)(7) company; (2) real estate held for investment purposes; (3) commodity interests (as defined under Investment Company Act Rule 2a51-1(b)) held for investment purposes; (4) physical commodities (as defined under Investment Company Act Rule 2a51-1(b)) held for investment purposes; (5) to the extent not securities, financial contracts (as such term is defined in Investment Company Act Section 3(c)(2)(B)(ii) entered into for investment purposes; (6) in the case of a prospective investor that is a Section 3(c)(7) company, a company that would be an investment company but for the exclusion provided by Investment Company Act Section 3(c)(1), or a commodity pool, any amounts payable to such prospective investor pursuant to a firm agreement or similar binding commitment pursuant to which a person has agreed to acquire an interest in, or make capital contributions to, the prospective investor upon the demand of the prospective investor; and (7) cash and cash equivalents (including foreign currencies) held for investment purposes.

[3] The term "family office" for this purpose generally means a company (including its directors, partners, members, managers, trustees, and employees acting within the scope of their position or employment) that (1) has no clients other than family clients; provided that if a person that is not a family client becomes a client of the family office as a result of the death of a family member or key employee or other involuntary transfer from a family member or key employee, that person shall be deemed to be a family client for one year following the completion of the transfer of legal title to the assets resulting from the involuntary event; (2) is wholly owned by family clients and is exclusively controlled (directly or indirectly) by one or more family members and/or family entities; and (3) does not hold itself out to the public as an investment adviser.

[4] The term "family client" for this purpose generally means (i) any family member; (ii) any former family member; (iii) any key employee; (iv) any former key employee, provided that upon the end of such individual's employment by the family office, the former key employee shall not receive investment advice from the family office (or invest additional assets with a family office-advised trust, foundation or entity) other than with respect to assets advised (directly or indirectly) by the family office immediately prior to the end of such individual's employment, except that a former key employee shall be permitted to receive investment advice from the family office with respect to additional investments that the former key employee was contractually obligated to make, and that relate to a family-office advised investment existing, in each case prior to the time the person became a former key employee; (v) any non-profit organization, charitable

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foundation, charitable trust (including charitable lead trusts and charitable remainder trusts whose only current beneficiaries are other family clients and charitable or non-profit organizations), or other charitable organization, in each case for which all the funding such foundation, trust or organization holds came exclusively from one or more other family clients; (vi) any estate of a family member, former family member, key employee, or, subject to certain conditions, former key employee; (vii) any irrevocable trust in which one or more other family clients are the only current beneficiaries; (viii) any irrevocable trust funded exclusively by one or more other family clients in which other family clients and non-profit organizations, charitable foundations, charitable trusts, or other charitable organizations are the only current beneficiaries; (ix) any revocable trust of which one or more other family clients are the sole grantor; (x) any trust of which: each trustee or other person authorized to make decisions with respect to the trust is a key employee; and each settlor or other person who has contributed assets to the trust is a key employee or the key employee's current and/or former spouse or spousal equivalent who, at the time of contribution, holds a joint, community property, or other similar shared ownership interest with the key employee; or (xi) any company wholly owned (directly or indirectly) exclusively by, and operated for the sole benefit of, one or more other family clients; provided that if any such entity is a pooled investment vehicle, it is excepted from the definition of "investment company" under the Investment Company Act.

[5] The term "qualified client" generally means (a) natural person who, or a company that, immediately after entering into the contract has at least $1 million under the management of the private fund manager; (b) a natural person who, or a company that, the private fund manager entering into the contract (and any person acting on his behalf) reasonably believes, immediately before entering into the contract, either: (i) has a net worth (together, in the case of a natural person, with assets held jointly with a spouse) of more than $2.1 million; or (ii) is a qualified purchaser as defined in section 2(a)(51)(A) of the Investment Company Act at the time the contract is entered into; or (c) a natural person who immediately prior to entering into the contract is: (i) an executive officer, director, trustee, general partner, or person serving in a similar capacity, of the private fund manager; or (ii) an employee of the private fund manager (other than an employee performing solely clerical, secretarial or administrative functions with regard to the private fund manager) who, in connection with his or her regular functions or duties, participates in the investment activities of such private fund manager, provided that such employee has been performing such functions and duties for or on behalf of the investment adviser, or substantially similar functions or duties for or on behalf of another company for at least 12 months (a knowledgeable employee). Note, Section 418 of the Dodd-Frank Act requires the SEC to issue an order every five years to adjust for inflation the dollar amount thresholds in Rule 205-3's assets-under-management and net worth tests based on the Personal Consumption Expenditures Chain-Type Price Index (PCE Index, published by the United States Department of Commerce), rounded to the nearest $100,000. The last increase became effective in August 2016.

[6] The term "qualified purchaser" generally means, (a) an individual who owns not less than $5 million in "Investments" either separately or jointly or as community property with his or her spouse; (b) an entity, acting for its own account or the accounts of other "qualified purchasers," that in the aggregate owns and invests on a discretionary basis not less than $25 million in "Investments"; (c) a "family company" (as defined under the Investment Company Act) that owns not less than $5 million in "Investments"; (d) an entity (other than a trust), each of the beneficial owners of which is a "qualified purchaser"; or (e) certain QIBs. For purposes of determining the whether the outstanding securities of a Section 3(c)(7) Company are owned exclusively by qualified purchasers, funds excluded securities beneficially owned by knowledgeable employees pursuant to Investment Company Act Rule 3c-5.

[7] Not all additional eligibility requirements, regulatory, or otherwise, are discussed in this client advisory. Please consult legal counsel to determine the interplay of any such requirements with the new expanded definitions of accredited investors and QIBs.

The final rule is effective December 8, 2020.

The SEC's final rule is available at https://www.sec.gov/rules/final/2020/33-10824.pdf.

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SEC's Office of Compliance Inspections and Examinations Issues COVID-19 Risk Alert

08.18.20

OCIE's latest Risk Alert focuses on six areas:

- protection of investors' assets
- supervision of personnel
- practices relating to fees, expenses, and financial transactions
- investment fraud
- business continuity
- the protection of investor and other sensitive information.

Who Needs to Know

Broker-Dealers and Investment Advisers

Why It Matters

Broker-dealers and investment advisers should take heed of OCIE's guidance and assess their compliance policies and procedures accordingly. Compliance should consider, in consultation with their counsel, documenting special reviews undertaken to address this particular Risk Alert to show continued vigilance during the pandemic.

On August 12, the SEC's Office of Compliance Inspections and Examinations (OCIE), issued a Risk Alert highlighting COVID-19 compliance risks and considerations for broker-dealers and investment advisers. Through its exams, operations, and outreach efforts with SEC registrants, OCIE has observed the impacts of COVID-19 on registrants and their resulting operational resiliency challenges.

OCIE's latest Risk Alert highlights six categories of OCIE's observations and recommendations for broker-dealers and investment advisers: (1) protection of investors' assets; (2) supervision of personnel; (3) practices relating to fees, expenses, and financial transactions; (4) investment fraud; (5) business continuity; and (6) the protection of investor and other sensitive information.

Observations and Recommendations

1. *Protection of Investor Assets*. OCIE remains focused on the integrity of investor assets. Its Risk Alert notes a greater risk of theft or loss of investor assets during emergency situations, including the current COVID-19 pandemic, which has caused some firms to modify normal procedures in processing investor deposits or asset instructions. OCIE suggests that firms review their policies and procedures around these issues, including steps for verifying the identify of investors and the authenticity of disbursement instructions. It also suggests that firms consider disclosing to investors that checks or assets mailed from physical office locations may experience delay due to COVID-19 issues.
2. *Supervision of Personnel*. OCIE's Risk Alert emphasizes that firms retain their obligations to supervise personnel and investment activities even after shifting to a teleworking environment or making other changes in response to COVID-19. OCIE encourages firms to review and modify as necessary their supervisory and compliance policies and procedures around these issues. It also specifically calls

attention to the impact of limited on-site due diligence reviews and other resource constraints associated with reviewing third-party managers, investments, and portfolio holding companies.

3. *Fees, Expenses, and Financial Information*. The Risk Alert notes that the recent market volatility and the resulting impact on investor assets and the related fees collected by firms may have increased financial pressures on firms. OCIE warns that the extreme pressures caused by COVID-19 may increase the risk for misconduct or error regarding financial conflicts of interest, as well as erroneous or improper fees and expenses charged to investors, to compensate for lost revenue. OCIE recommends that firms review their fees and expenses policies and procedures, and consider enhancing their compliance monitoring during this time. OCIE's concerns regarding fees and expenses echo those from its June 23 risk alert on Observations from Examinations of Investment Advisers Managing Private Funds, discussed in more detail in our previous client advisory. Also, since 2014, Troutman Pepper has helped spearhead a biennial fees and expenses survey published by *PFM*, in which fund managers share how they deal with fees and expenses. An update to this survey will be published this fall. Listen to a podcast on the previous study results.

4. *Investment Fraud*. OCIE's Risk Alert warns firms of the potential for increased fraud, including fraudulent offerings, during crisis situations like the current COVID-19 pandemic. It urges firms to be vigilant for these risks, particularly when conducting due diligence or allocating investments. The Risk Alert also reminds registrants of their obligation to provide advice that is in the best interest of each investor, which requires a reasonable understanding of both the investor and the proposed investment. For more information on firms' duty to act in the best interest of their clients, see our prior client advisory on investment advisers' fiduciary duty obligations, and see the following articles on broker-dealer's standard of care under Regulation Best Interest: "The Foundation Of A Regulation Best Interest Compliance Program," "Patchwork Of Broker Conduct Regs Complicates Compliance," and "Firms Should Stay Course Amid New Broker Standard Suits." In particular, firms should be on the lookout for investments in companies purporting to have cures, vaccines, or curative drugs for COVID-19 infections or access to personal protective equipment, testing, or other preventatives.

5. *Business Continuity*. OCIE notes that as COVID-19 triggered rapid changes to society and the workplace, firms should review their policies and procedures around business continuity planning to ensure they can operate effectively during emergency events. In particular, OCIE encourages firms to evaluate their work-from-home policies and procedures in light of COVID-19. The alert also suggests that firms give thought to security and support for firm facilities (which may be largely vacant), including, for example, additional security to protect servers and systems data. For a more detailed discussion on business continuity during the pandemic, see our prior article on the Do's and Don'ts of Working from Home.

6. *Protection of Sensitive Information*. OCIE observed that a teleworking environment may increase risks of mishandling or accidental loss of investors' personally identifiable information. OCIE's Risk Alert attributes the heightened risk of losing confidential information to the greater number of servers and personal devices (*i.e.,* computers, tablets, and mobile devices) across which the information may be transmitted. This breadth of devices and broader dissemination of information increases opportunities for electronic fraud or theft, such as by phishing schemes. Because of this heightened risk, OCIE recommends firms undertake a review of their security systems, policies, and procedures to evaluate any weaknesses or consider possible enhancements. For more information, see our article from the February 27 issue of *The Legal Intelligencer* titled, "Report Provides Guidance on How Companies Should Address Cyber Risks."

In addition to the observations and recommendations discussed above, the Risk Alert also includes links to various resources regarding the SEC's response to COVID-19 and related activities. Broker-dealers and

investment advisers should take heed of OCIE's guidance and assess their compliance policies and procedures accordingly. Compliance should consider, in consultation with their counsel, documenting special reviews undertaken to address this particular Risk Alert to show continued vigilance during the pandemic.

The Risk Alert is available at https://www.sec.gov/files/Risk%20Alert%20-%20COVID-19%20Compliance.pdf.

SEC Proposes to Improve the Retail Investor Experience Through Modernized Fund Shareholder Reports and Disclosures

08.10.20

In a substantial August 5 release, the SEC proposed changes to the existing disclosure framework for mutual funds and ETFs that, if adopted, would represent a comprehensive refinement to the current framework. The proposal follows the SEC's 2018 release seeking industry comments on the current disclosure framework, which received comment from notable industry participants and retail investors who were invited to submit a short "feedback flier" questionnaire. Improvement of the Main Street or retail investor experience, including the design, delivery, and content of disclosure, has been a priority for the SEC and its Division of Investment Management under current Chairman Jay Clayton.

Shareholder Reports:

- Under the proposal, shareholder reports would be designed to highlight, among other information, fund expenses, performance information, including a concise management discussion of fund performance, illustrations of holdings, and certain material fund changes.
- The proposal seeks changes to the format and presentation of shareholder reports to present information in a consistent order. It encourages open-end funds to use graphic or text features in the reports, such as tables, bullet points, and question-and-answer formats. In addition, it provides flexibility for open-end funds to produce electronic versions of their shareholder reports with interactive features.
- Certain information currently included in an open-end fund shareholder reports and of less relevance to retail investors, such as a schedule of investments, would be available online, delivered free of charge upon request, and filed on a semi-annual basis with the SEC on Form N-CSR.
- The proposal includes a hypothetical, new streamlined shareholder report, including a comparison to an existing shareholder report. The proposal also included a new "feedback flier" to solicit feedback on the proposed changes.

Prospectus:

- The proposal would create Rule 498B, under which investors would continue to receive a fund prospectus in connection with an initial investment in an open-end fund, but funds would discontinue the practice of delivering annual prospectus updates to shareholders.
- Instead of annual prospectus updates, open-end funds would provide relevant information through the new shareholder report format (including a summary in the annual report of material changes to the fund over the prior year) and by providing timely notifications regarding material fund changes as they occur. Current versions of the fund's prospectus would remain available online and would be delivered to shareholders upon request in paper or electronically, consistent with the shareholder's delivery preference.
- Open-end fund prospectus disclosure related to fund fees (the presentation of which also would be updated in shareholder reports) and risks would be amended to help improve investor comprehension. Specifically, the current fee table in the summary section of a fund's prospectus would be replaced with a simplified "fee summary," and the existing fee table would be moved to another section of the statutory prospectus. The proposal also would modify the current prospectus fee table requirements by refining the scope of funds that must disclose acquired fund fees and expenses (AFFE), permitting funds that invest 10% or less of their total assets in acquired funds to omit the AFFE line item in the fee

table, and instead disclose the amount of the fund's AFFE in a footnote to the fee table and fee summary.

- Prospectus risk disclosure would be modified by streamlining it in the prospectus to focus on essential information, and clarify current form requirements that emphasize the disclosure of "principal" risks.

Rule 30e-3:

- In tandem with the SEC's 2018 request for comment, the SEC adopted Rule 30e-3 under the Investment Company Act of 1940, which allowed for funds to use a "notice and access" method for the delivery of shareholder reports. Rule 30e-3 is available for use by funds commencing January 1, 2021.
- The proposal would amend the scope of Rule 30e-3 to exclude open-end funds. By sending tailored annual and semi-annual reports under the proposal, funds would satisfy shareholder report transmission requirements more directly than they would via the current Rule 30e-3 notices.

Advertising Rule Amendments:

- The proposal also would amend specific investment company advertising rules to standardize certain fee- and expense-related information (and to be consistent with prospectus requirements).

The proposal will be published on SEC.gov and in the Federal Register. The public comment period will begin following publication and remain open for 60 days after publication in the Federal Register.

The SEC's proposal and form amendments are available at https://www.sec.gov/rules/proposed/2020/33-10814.pdf.

A copy of the SEC's Hypothetical Streamlined Shareholder Report is available at https://www.sec.gov/files/final_2020_im_annual-shareholder report.pdf.

SEC Adopts Amendments to Provide Investors More Information on Proxy Voting Advice

07.27.20

On July 22, the SEC voted to adopt amendments (Amendments) to certain rules governing proxy solicitations under the Securities Exchange Act of 1934 (Exchange Act). The Amendments will ensure that clients of proxy voting advice businesses have reasonable and timely access to more transparent, accurate, and complete information on which to make voting decisions, without imposing undue costs or delays that could negatively impact the timely provision of proxy voting advice. The Amendments largely resemble those first proposed by the SEC on November 5, 2019 (Proposal), with some exceptions discussed below.

Highlights of the Amendments include the following:

- **Rule 14a-1(l).** Consistent with the Proposal, the SEC adopted an amendment to Exchange Act Rule 14a-1(l), modifying the definition of the terms “solicit” and “solicitation” to add new paragraph (A) to Rule 14a-1(l)(1)(iii) to include within the definition any proxy voting advice that makes a recommendation to a shareholder as to its vote, consent, or authorization on a matter for which shareholder approval is solicited, and that is furnished by a person who markets its expertise as a provider of such advice, separately from other forms of investment advice, and sells such advice for a fee. Adoption of this amendment codifies the long-held SEC position that providing proxy voting advice generally constitutes a solicitation under the federal proxy rules. Rule 14a-1(l) is further amended under the Amendments to clarify that “solicitations” do not include the furnishing of any proxy voting advice by a person only in response to an unprompted request.
- **Rules 14a-2(b)(1) and 14a-2(b)(3).** These Amendments revise the exemptions from the information and filing requirements provided in Exchange Act Rule 14a-2(b), such that proxy voting advice businesses relying on these exemptions would be required to adhere to the following conditions:
    - They must include prominent disclosure of material conflicts of interest as specified in new Rule 14a-2(b)(9)(i) in their proxy voting advice to clients, adopting the requirement substantially as proposed in the Proposal; and
    - They must have adopted and publicly disclosed written policies and procedures reasonably designed to ensure the following: (1) registrants that are the subject of the proxy voting advice disseminated have such advice made available to them at or before the advice is circulated to the proxy voting advice business’s clients (new Rule 14a-2(b)(9)(ii)(A)); and (2) the proxy voting advice business provides its clients with a mechanism by which they can reasonably be expected to become aware of any written statements regarding its proxy voting advice by registrants who are the subject of such advice, in a timely manner before the security holder meeting (new Rule 14a-2(b)(9)(ii)(B)).
    - New Rules 14a-2(b)(9)(ii)(A) and (B) differed from the requirements included in the Proposal and were characterized by the SEC as less prescriptive and more “principles-based” requirements, with each including the following non-exclusive safe harbors: (i) a proxy voting advice business will be deemed to satisfy Rule 14a-2(b)(9)(ii)(A) if its written policies and procedures are reasonably designed to provide registrants with a copy of its proxy voting advice, at no charge, no later than the time it is disseminated to the business’ clients — and the proxy advice business’s policies and procedures may include conditions requiring registrants to (a) file their definitive proxy statement at least 40 calendar days before the security holder meeting and (b) expressly acknowledge that they will only use the proxy voting advice for their internal purposes and/or in connection with the solicitation, and will not publish or otherwise share the proxy voting advice except with the registrant’s employees or advisers; (ii) the proxy

voting advice business will be deemed to satisfy the requirements of Rule 14a-2(b)(9)(ii)(B) if its written policies and procedures are reasonably designed to inform clients receiving advice, whether on an electronic client platform, via email, or other electronic means (and further includes an active hyperlink to those materials on EDGAR when available), that the registrant who is the subject of such advice has notified the business that he/she intends to file or has filed additional soliciting materials regarding the advice.

- **Rule 14a-9.** Largely consistent with the Proposal, the Amendments also supplement Rule 14a-9 to include instances in which the failure, when furnishing proxy voting advice, to disclose certain material information could be considered false or misleading. Such material information could include information about the proxy voting advice business' methodology, sources of information, or conflicts of interest.

The Amendments' effective date is November 2, but the SEC has provided a transition period through December 1, 2021 with respect to Rule 14a-2(b)(9), based on commenter feedback and the SEC's interest in limiting unnecessary disruptions during the peak proxy season. The transition period only applies with respect to the Amendments to Rule 14a-2(b)(9) and does not extend to the Amendments to Rule 14a-1(l) and Rule 14a-9. Because these other Amendments codify existing SEC interpretations and guidance without imposing new obligations that necessitate significant time for preparation, the SEC did not believe the same rationale for a transition period existed.

In conjunction with the Amendments, the SEC also supplemented, in question and answer format, prior issued guidance regarding investment advisers' proxy voting responsibilities. According to the SEC, the supplemental guidance is intended to further clarify how the fiduciary duty and Rule 206(4)-6 under the Investment Advisers Act of 1940 relate to an investment adviser's exercise of voting authority on behalf of its advisory clients. It also encourages investment advisers and proxy advisory firms to review relevant policies and practices in light of the guidance in advance of the next proxy season.

The SEC's final rule is available at https://www.sec.gov/rules/final/2020/34-89372.pdf.

The SEC's guidance is available at https://www.sec.gov/rules/policy/2020/ia-5547.pdf.

Litigation and Enforcement

Plaintiff's Law Firm Fined for Reckless Litigation in 1940 Act Excessive Fee Lawsuit

09.30.20

A Colorado district court fined a plaintiff's law firm up to $1.5 million for recklessly pursuing 1940 Act excessive fee litigation through trial despite having meritless claims. Excessive fee litigation appears to be going away in the mutual fund industry. According to a recent ICI Mutual report, no new Section 36(b) excessive fee suits have been filed since 2018. Out of 29 such lawsuits filed since 2010, the vast majority have settled or have been dismissed, with only a few cases still pending. To date, none of the excessive fee lawsuits have resulted in a favorable judgment for plaintiffs.

A few remaining Section 36(b) cases in the industry have not been settled or terminated. We will continue to follow such cases and their resolution.

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