Articles + Publications | August 2021

Investment Management Update – August 2021

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Covering legal developments and regulatory news for funds, their advisers, and industry participants through June 2021.

TABLE OF CONTENTS

RULEMAKING AND GUIDANCE

SEC Issues Order Approving Increased Asset Thresholds for Qualified Client Status in Rule 205-3 Under the Investment Advisers Act

06.17.21

On June 17, the SEC issued an Order amending the dollar amount thresholds in the definition of “qualified client” under Rule 205-3 of the Investment Advisers Act of 1940 (Investment Advisers Act). Effective August 16, the SEC has increased the net worth threshold for qualified client status to $2.2 million, and has increased the dollar amount of the assets-under-management test for that status to $1.1 million. Under grandfathering rules, the increased threshold amounts will not affect managed accounts nor the subscription agreements of Section 3(c)(1) private funds that were entered into before the effective date of August 16, 2021.

In 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) amended Section 205(e) of the Investment Advisers Act to provide that, by July 21, 2011, and every five years thereafter, the SEC will adjust the dollar amount thresholds included in rules issued under Section 205(e), for the effects of inflation. This Order allows the SEC to comply with the requirement in the Dodd-Frank Act.

Section 205(a)(1) of the Investment Advisers Act generally prohibits an investment adviser from entering into, extending, renewing, or performing any investment advisory contract that provides for compensation to the adviser based on a share of capital gains on, or capital appreciation of, the funds of a client (also known as performance compensation or performance fees). Section 205(e) provides an exemption if the contract is with persons that the SEC determines do not need the protections of the prohibition. Rule 205-3 exempts an investment adviser from the prohibition against charging a client with performance fees when the client is a “qualified client.” The rule allows an adviser to charge performance fees if the client has at least a certain dollar amount in assets under management (now raised to $1.1 million) with the adviser immediately after entering into the advisory contract (known as the assets-under-management test), or if the adviser reasonably believes, immediately before entering into the contract, that the client has a net worth of more than a certain dollar amount (now raised to $2.2 million) (known as the net worth test).”

Investment advisers should update their investment advisory agreements, subscription agreements, and offering documents for Section 3(c)(1) private funds to conform to the increased thresholds under Rule 205-3 of the Investment Advisers Act to the extent that certain advisory relationships and offerings are ongoing past August 16, 2021.

Staff Statement on Funds Registered Under the Investment Company Act Investing in the Bitcoin Futures Market

05.11.21

In a Statement issued on May 11, the Staff of the SEC’s Division of Investment Management provided additional information regarding its positions on investments in Bitcoin futures by funds registered under the Investment Company Act, in particular open-end mutual funds (funds). As noted in the Statement, the Staff previously addressed the same topic in a letter issued in January 2018 (letter), from which it received extensive feedback from industry participants. Bitcoin futures began trading in December 2017, shortly before the letter’s release. The letter discussed aspects of valuation, liquidity, custody, arbitrage mechanisms for exchange traded funds (ETFs), and potential manipulation and other risks associated with cryptocurrency-related markets, in addition to funds’ compatibility with digital currencies as an asset class.

The Statement, addressed in part to current or potential fund investors, encourages potential investors in funds with exposure to Bitcoin futures to consider funds' risk disclosure, the investor's risk tolerance, and the possibility of investor loss. The Statement reminds investors that Bitcoin and Bitcoin futures are comparatively speculative investments, with higher than average volatility and potential for inherent fraud and manipulation.

Noting that cash-settled bitcoin futures have emerged as perhaps the most popular method for fund investors to gain access to cryptocurrencies and the concurrent development of this market since their introduction in 2017, the Statement highlights the following specific aspects that the Staff, in coordination with the staff from the SEC's Division of Economic and Risk Analysis and Division of Examinations, will continue to monitor:

- The liquidity and number of participants in the Bitcoin futures market and whether the market is adequately supporting funds' investments in Bitcoin futures;
- Funds' ability to liquidate Bitcoin futures positions to meet redemption needs, and the capacity of funds' derivatives risk management programs along with the extent of any leverage obtained through derivatives;
- Impacts to funds' valuations of bitcoin futures as well as impacts to valuations within the broader market and any disruptions to valuation;
- Funds' liquidity classifications of Bitcoin futures' positions and the basis for such classification in connection with funds' compliance with the open-end fund liquidity rule;
- The impact of the potential for fraud or manipulation in underlying Bitcoin markets and any influence on the Bitcoin futures market; and
- Whether ETFs could potentially invest in the Bitcoin futures market — with the distinction that, unlike funds, ETFs cannot prevent additional investor assets from coming into the ETF in certain circumstances.

Despite notable industry interest in ETFs with Bitcoin exposure, the Statement indicates that the Staff currently believes that such exposure should currently be limited to funds investing in Bitcoin futures, with strategies that support such an investment and full disclosure of material risks. The Staff, however, does encourage further engagement from market participants with respect to the use of cryptocurrencies as investments and the appropriateness of various investment vehicles, including closed-end funds, for different iterations of cryptocurrencies.

A copy of the Staff's Statement is available at: https://www.sec.gov/news/public-statement/staff-statement-investing-bitcoin-futures-market.

Division of Investment Management's Staff Statement Regarding Termination Notice for Exemptive Relief and Withdrawal of Staff Letters Related to COVID-19 Response

04.15.21

On April 15, the Staff of the Division of Investment Management issued a Statement updating some of the temporary exemptive relief it had previously granted in response to the COVID-19 pandemic.

The SEC's extension of its order providing an exemption from the in-person voting requirements for boards of directors of either registered management investment companies or business development companies is still in effect. These requirements arise under Sections 15(c) and 32(a) of the Investment Company Act, and Rules 12b-1(b)(2) and 15a-4(b)(2)(ii) under the Investment Company Act. The exemption regarding the in-person

requirement dates back to March 25, 2020.

For a copy of this Order see: https://www.sec.gov/rules/other/2020/ic-33824.pdf.

Certain other measures taken by the Staff in light of the COVID-19 pandemic are no longer in effect. In March 2020, the SEC issued a conditional exemptive order permitting registered open-end investment companies (except money market funds) and insurance company separate accounts registered as unit investment trusts, to obtain short-term funding by borrowing from affiliated persons or under an inter-fund lending facility, even if the funds involved in the transaction did not have an inter-fund lending order (the Conditional Order). Additionally, in March 2020, the Division of Investment Management issued two no-action letters addressed to the Investment Company Institute concerning the ability of certain affiliates to purchase (i) securities from a money market fund, and (ii) debt securities from a mutual fund. The Conditional Order was terminable upon two weeks' public notice from the Staff, and each of the two letters stated that it would cease to be effective upon public notice from the Staff. In late March 2021, the relief provided by the Conditional Order terminated, and the two no-action letters were withdrawn, effective April 30, 2021.

A copy of the Staff's Statement is available at: https://www.sec.gov/investment/staff-statement-im-covid-19-relief-termination.

SEC AND SRO NEWS

Changes at the SEC: SEC Appoints New Jersey Attorney General Gurbir S. Grewal as Director of Enforcement

06.29.21

On June 29, the SEC announced that Gurbir S. Grewal has been appointed Director of the Division of Enforcement, effective July 26, 2021. Mr. Grewal replaces Melissa Hodgman, the Enforcement Division's prior Acting Director.

Mr. Grewal most recently served as Attorney General for the State of New Jersey since January 2018. Before becoming Attorney General, Mr. Grewal's biography includes having served as the Bergen County prosecutor. Mr. Grewal graduated *cum laude* from the Georgetown University School of Foreign Service in 1995. He obtained his law degree from the College of William & Mary, Marshall-Wythe School of Law in 1999.

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