Investment Services Regulatory Update

June 2020

Monthly Version

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NEW RULES

SEC Amends Financial Reporting Rules for Investment Company Business Combination Transactions

On May 20, 2020, the SEC adopted amendments to the financial statement disclosure requirements under Regulation S-X related to acquisitions and dispositions involving investment companies.

First, the amendments streamline applicable significance tests under Regulation S-X to more closely align with significance tests under the Investment Company Act of 1940. Amended Rule 1-02(w)(2) of Regulation S-X creates a separate definition of "significant subsidiary" for investment companies using modified versions of the investment test and income test set forth in Rule 8b-2 under the Investment Company Act, as follows:

- **Investment Test.** Under the amended investment test, an acquisition will be significant if the value of a fund's investment in and advances to the tested subsidiary (i.e., the acquired fund) exceed 10 percent of the value of the fund's total investments as of the most recently completed fiscal year.
- **Income Test.** Under the amended income test, an acquisition would be significant if the total investment income of the tested subsidiary for the most recently completed pre-acquisition fiscal year is greater than either (1) 80 percent of the total consolidated change in net assets resulting from the acquiring fund's operations for the most recently completed fiscal year or (2) 10 percent of the total change in net assets resulting from the acquiring fund's operations for the most recently completed fiscal year, if the investment test condition also exceeds 5 percent. The amended income test includes income from dividends, interest, other income, net realized gains and losses on investments and the net change in unrealized gains and losses on investments.
- **Asset Test.** Pursuant to the amendments, the asset test under Rule 1-02(w) has been eliminated for investment companies.

The amendments also address the financial statements required for acquiring and acquired investment funds, including registered investment companies and private funds relying on Sections 3(c)(1) or 3(c)(7) of the Investment Company Act. New Rule 6-11 of Regulation S-X applies a facts and circumstances evaluation to determine whether a fund acquisition has occurred. This facts and circumstances evaluation uses the significant subsidiary criteria of Rule 1-02(w)(2), as described above, modified to use the investment test at a 20 percent, rather than a 10 percent, significance threshold, and to exclude the 80 percent condition of the income test. If this significance test is met, one year of audited financial statements of an acquired fund would need to be provided. For private funds, the new rule allows financial statements to be filed in accordance with U.S. GAAP.

Additionally, the amendments eliminated the requirement for investment companies to provide pro forma financial statements in connection with business combination transactions. Instead, the amendments require investment companies to provide certain supplemental financial information about the combined fund post-acquisition, including, among other things, (1) a pro forma fee table; (2) a schedule of the acquired fund's investments along with a related narrative discussion, if the acquisition causes material changes to the acquired fund's investment portfolio resulting from applicable investment restrictions; and (3) narrative disclosure about material differences between the accounting policies of the acquired fund and those of the combined fund.

Lastly, the amendments modify certain financial disclosure requirements of Form N-14 to align those with the requirements of new Rule 6-11, as described above.

The SEC's final rule is available here.

REGULATORY RELIEF

SEC Extends Relief from 1940 Act In-Person Voting Requirements

As previously reported, in March 2020, the SEC issued exemptive orders providing relief from certain provisions of the Investment Company Act of 1940 to registered funds in light of the outbreak of coronavirus disease 2019 (COVID-19). Among other things, these orders provided relief from the in-person voting requirements under Sections 15(c) and 32(a) of the 1940 Act and Rules 12b-1(b)(2) and 15a-4(b)(2)(ii) relating to the approval or renewal of advisory and underwriting agreements; the approval or renewal of distribution plans, agreements or arrangements; and the appointment of auditors. The relief was made available if: (1) reliance on the order would be necessary or appropriate due to circumstances related to the current or potential effects of COVID-19, (2) the votes cast for such matters would be cast at a meeting in which directors may participate by any means of communications that allow all directors to hear each other simultaneously during the meeting; and (3) the board, including a majority of independent directors, would ratify such actions at the next in-person meeting. The March orders provided relief for votes held from March 13, 2020 through August 15, 2020.

On June 19, 2020, the SEC, citing its monitoring of COVID-19 and its current understanding of the circumstances, issued a new order extending the previously issued relief from the 1940 Act's in-person voting requirements for votes held through December 31, 2020. The relief remains subject to the same conditions set forth in the March orders.

A copy of the order is available here.

GUIDANCE AND ALERTS

SEC Staff Issues No-Action Letter Regarding Fund Participation in the Federal Reserve Board's 2020 Term Asset-Backed Loan Facility

On May 27, 2020, the SEC staff issued a no-action letter to the Investment Company Institute (ICI) and the Securities Industry and Financial Markets Association (SIFMA) permitting registered funds to participate in the Term Asset-Backed Securities Loan Facility (TALF 2020) program established by the Board of Governors of the Federal Reserve System (Fed) and the U.S. Department of the Treasury on March 23, 2020. TALF 2020 was established to address the effects of the COVID-19 pandemic on financial markets to support the availability of credit to consumers and businesses through the Fed's issuance of loans for the purchase of AAA-rated asset-backed securities (ABS) backed by student loans, auto loans, credit card loans, loans guaranteed by the Small Business Administration and certain other assets. TALF loan proceeds are disbursed to the borrower upon receipt by TALF 2020's custodian of eligible collateral (i.e., TALF-eligible ABS), an administrative fee and a "haircut" (i.e., a percentage of a TALF-eligible ABS's value calculated in accordance with a standardized schedule). A similar program was established in 2008 in response to the global financial crisis (TALF 2008).

Following the establishment of TALF 2008, the SEC staff in 2009 issued two no-action letters regarding the participation by registered funds in that program. The first no-action letter, issued to Franklin Templeton Investments on June 19, 2009, provided that the SEC staff would not seek enforcement action against a registered fund that participated in TALF 2008 (1) under Section 18 of the Investment Company Act of 1940 for failure to treat TALF loans as senior securities or (2) under Section 17(f) of the 1940 Act or related rules with respect to the unique custody arrangements necessitated by TALF loans. The Franklin Templeton no-action letter also required participating funds to segregate liquid assets equal

in value to the outstanding principal and interest under each TALF loan. The second no-action letter, issued to T. Rowe Price Associates, Inc. on October 8, 2009, provided that the SEC staff would not seek enforcement action under Section 17(a) or 17(d) of the 1940 Act or Rule 17d-1 thereunder for purchasing interests in a private pooled investment vehicle formed for the specific purpose of acquiring eligible collateral and obtaining TALF loans. Reliance on each no-action letter was subject to certain conditions set forth in each letter.

The May 2020 no-action letter issued to the ICI and SIFMA affirmed the no-action positions taken in 2009 relating to the participation by registered funds in TALF 2008, noting that TALF 2020 and TALF 2008 have substantially similar terms and conditions. Additionally, the May 2020 no-action relief expands upon the 2009 relief issued to T. Rowe Price by permitting third parties to rely on that relief and by extending that relief to Section 57(a) of the 1940 Act, which permits reliance by business development companies.

The SEC staff's May 27, 2020 no-action letter issued to the ICI and SIFMA is available here.

SEC Chairman Confirms June 30 Compliance Date for Regulation Best Interest and Form CRS

On June 15, 2020, SEC Chairman Jay Clayton released a public statement confirming the June 30, 2020 compliance date for Regulation Best Interest (Reg BI) and Form CRS. Reg BI establishes a new standard of conduct for broker-dealers when making a recommendation of any securities transaction or investment strategy (including account recommendations) to a retail customer. Form CRS is a disclosure document applicable to broker-dealers and registered investment advisers with retail investors, and is meant to reduce investor confusion about fees, conflicts of interest and the required standard of conduct for a particular firm. In his remarks, Mr. Clayton noted the SEC had engaged extensively over the past year with broker-dealers, investment advisers, market participants and regulatory partners such as FINRA, regarding the implementation of Reg BI and Form CRS. Based on the considerable progress observed, Mr. Clayton reiterated an earlier position from April 2020 that the June 30, 2020 compliance date for both rules was appropriate. Mr. Clayton further noted that the SEC's work over the past several months had strengthened his view that the effects of the COVID-19 pandemic weighed substantially in favor of implementing Reg BI and Form CRS requirements as soon as practicable.

Chairman Clayton's public statement is available here.

SEC Staff Reverses Position on State Control Share Statutes for Closed-End Funds

On May 27, 2020, the staff of the SEC's Division of Investment Management withdrew previously issued guidance addressing the intersection between state control share acquisition statutes (control share statutes) and the voting requirements under Section 18(i) of the Investment Company Act of 1940. Under its new no-action position, the SEC staff stated that it would not recommend enforcement action against a closed-end fund for opting into and triggering a control share statute if the board's decision to do so was taken with reasonable care on a basis consistent with other applicable duties and laws.

Generally, control share statutes provide that when a shareholder acquires a certain percentage of voting power of a company equal to a "control share," that shareholder will have no or limited voting rights with respect to those shares. The percentage of voting power equal to a control share is specified in the statue (e.g., one-third but less than a majority). Voting rights can typically be restored to control shares only by a vote of the other shareholders. Control share statutes provide companies with the ability to prevent certain changes of control and protect from shareholder activism. Control share statutes, like other state corporation statutes, require companies to opt-in or opt-out of compliance with the statute's provisions.

The new guidance is a reversal from the SEC staff's previous position on control share statutes taken in a 2010 no-action letter, in which the staff concluded that opting-in to control share statutes would be inconsistent with provisions of the Investment Company Act requiring that every share issued by an investment company have equal voting rights. As part of the SEC's undertaking to review prior staff guidance, announced by SEC Chairman Jay Clayton in 2018, the staff reviewed its previous guidance on control share statutes in light of "market developments" and "recent feedback from affected market participants" and determined to withdraw its prior guidance. In taking the new no-action position, the staff noted its expectation that a board's decision to opt-in to and trigger a control share statute take into account (1) the board's fiduciary duties to the fund, (2) applicable provisions of federal and state law and (3) the particular facts and circumstances surrounding the board's action. The staff also requests industry feedback to determine whether additional SEC action on this topic is warranted.

The SEC staff's guidance is available here.

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