April 11, 2022

Ropes & Gray's Investment Management Update February – March 2022

2022 ICI Investment Management Conference

As we have in prior years, Ropes & Gray will soon distribute its summary of the speeches and panels at this year's conference sponsored by the Investment Company Institute.

February – March Alerts on SEC Proposals

Since our prior IM Update, we have monitored a significant number of SEC proposals affecting the mutual fund/investment management industry, each of which we covered in a separate Alert. These Alerts are summarized below with a hyperlink to the full text of each Alert.

Update on Proposed Rules and Amendments Regarding SPAC Transactions
April 1, 2022
On March 30, 2022, the SEC proposed new rules and amendments regarding initial public offerings by special purchase acquisition companies ("SPACs") and business combination transactions involving shell companies (such as SPACs) and private operating companies. If adopted, the proposed rules will have a significant impact on SPACs throughout their life cycle, with particular focus on both the IPO and de-SPAC phases. The proposed rules also address the issue of whether a SPAC should be deemed an "investment company" under the 1940 Act by proposing a new safe harbor that would be available to a SPAC that satisfies specific conditions.

SEC Proposes New Reporting Regime for Short Sales
March 10, 2022
On February 25, 2022, the SEC proposed Rule 13f-21 and Form SHO under the Securities Exchange Act of 1934, which would require investors to file monthly reports disclosing certain short-selling activity. Form SHO would be confidentially filed with the SEC and would include detailed information about certain trading activities. The SEC would aggregate the reported information by security and publicly disclose only that aggregated information (without identifying any investors) monthly. The key elements of the SEC's proposal are summarized in this Alert.

SEC Proposes Cybersecurity Risk Management Rules for Registered Funds and Advisers
February 18, 2022
On February 9, 2022, the SEC published a release addressing Cybersecurity Risk Management for Investment Advisers, Registered Investment Companies, and Business Development Companies (the "Release"). The Release contained proposed new rules under the Advisers Act (Rules 206(4)-9 and 204-6) and the 1940 Act (Rule 38a-2) and amendments, which would require registered investment advisers and registered investment companies to implement cybersecurity risk management programs and new incident notification regimes.

SEC Proposes Substantial Changes to Beneficial Ownership Reporting
February 17, 2022
On February 10, 2022, the SEC proposed substantial amendments to the reporting regime for beneficial owners of greater than 5% in public companies. The SEC's proposal would accelerate the filing deadlines for Schedule 13D and Schedule 13G and require more frequent amendments to Schedule 13G filings. The proposal would also change how some cash-settled derivatives are treated and when investors have formed a "group" and must aggregate their holdings.

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SEC's Proposed Private Fund Reforms
February 15, 2022
On February 9, 2022, the SEC released proposed private fund reforms, which are summarized in this Alert. These rules and amendments are only proposed at this point and are subject to public review and comment. Comments on the rules are to be received by the SEC no later than April 25, 2022. We expect at least a few months, if not longer, between the end of the comment period and the publication of any final rules. The SEC proposed a one-year transition period following the rules' effective dates to provide time for advisers to come into compliance with the new and amended rules if they are adopted.

* * *

The following summarizes other recent legal developments of note affecting the mutual fund/investment management industry.

Federal Court Holds that Closed-End Funds' Control Share Provisions Are Impermissible

On February 17, 2022, the U.S. District Court for the Southern District of New York held that the "control share" provisions adopted by certain Nuveen closed-end funds (the "Nuveen Funds") violated Section 18(i) the 1940 Act.

Background. In May 2020, the staff of the SEC's Division of Investment Management (the "IM Staff") published a statement (the "Statement") that, effective immediately, withdrew the 2010 Boulder Total Return Fund no-action letter (the "Boulder Letter"), which concerned the interaction between Section 18(i) of the 1940 Act and a state control share acquisition statute (a "Control Share Statute"), and replaced the Boulder Letter with a new no-action position.

Under the new no-action position, the IM Staff stated that it would not recommend enforcement action to the SEC against a closed-end fund under Section 18(i) for opting in to and triggering a Control Share Statute, provided the fund's board decision to opt in was "taken with reasonable care on a basis consistent with other applicable duties and laws and the duty to the fund and its shareholders generally."

In October 2020, each of the Nuveen Funds adopted amended bylaws. Among the provisions added to the bylaws was an article titled "Control Share Acquisition" (the "Control Share Amendment"). The Control Share Amendment defines a "control share acquisition" as a shareholder's acquisition of shares after the date of the amendments' enactment which, taken together with shares already owned by that shareholder before the amendments, would lead to that shareholder's owning 10% or more of the total shares of a Nuveen Fund. Under the Control Share Amendment, a "control shareholder" is blocked from voting its stock acquired after the amendments' enactment, unless authorized by an "affirmative vote of the holders of a majority of all of the Shares entitled to vote. . . excluding [any shares owned by a control shareholder]."

The Lawsuit and the Court's Holding. In 2021, Saba Capital Management, LP ("Saba") sued the Nuveen Funds and their trustees alleging, among other things, that their adoption of the Control Share Amendment violated the requirements in Section 18(i) of the 1940 Act that every share of stock issued by a fund "shall be a voting stock and have equal voting rights with every other outstanding voting stock."

Although "voting stock" is not defined under the 1940 Act, the Court looked principally at the definition of "voting security" under the 1940 Act, which is defined as "any security presently entitling the owner or holder thereof to vote for the election of directors of a company." The Court reasoned that, when a shareholder acquires new stock in one of the Nuveen Funds, and the total amount of the stock in that closed-end fund constitutes a "control share acquisition," the shareholder's "newly acquired stock does not presently entitle her to vote." Instead, whether a control shareholder's newly acquired stock entitles her to vote "is contingent on an uncertain future event – whether the holders of the majority of stock, excluding stock owned by control shareholders, authorize it." Accordingly, the Court held, "the plain language of the [Section 18(i)] makes this contingency impermissible."

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In reaching its decision, the Court also found that the SEC's withdrawal of the Boulder Letter was not persuasive. The Court noted that the withdrawal "had no legal force or effect" and, unlike the Boulder Letter, did not contain any legal analysis of Section 18(i).

On February 25, 2022, the Nuveen Funds and their trustees filed a notice of appeal in the Second Circuit Court of Appeals.

Director William Birdthistle's Remarks at ICI Conference

The new Director of the SEC's Division of Investment Management, William Birdthistle, delivered the keynote remarks on March 28, 2022, the first day of the ICI's annual investment management conference (the full text is available here). He began by rejecting the "ominous" title of the December 2021 *Barron's* article published shortly after the SEC's announcement of his appointment: "Fund Critic Birdthistle to Take Reins at SEC's Division of Investment Management." The article described Mr. Birdthistle as "a prominent critic of the fund sector, arguing that the industry is riddled with bad behavior among asset managers." Director Birdthistle disagreed with this characterization, stating that he is a "fund critic" only in that he is "an aficionado of the form and [has] a deep appreciation for seeing it done to the best of its ability."

Director Birdthistle went on to consider "how can the investment company be done well?" Returns and fees were a particular focus of Director Birdthistle's remarks, and he answered his own question regarding why "investors in a fund with poor returns or high fees" do not exit the fund. He stated that some portions of the market "enjoy a great deal of movement in response to economic competition," while "others don't." Consequently, we "see a dearth of outflows from funds that underperform the market while charging relatively higher fees" and "sometimes in our least exemplary funds, we see less exit than we might expect."

Director Birdthistle posited that, "[p]erhaps some [investor vigilance] is simply beyond the scope of a reasonable investor." If a "substantial portion of costs are being drawn out of investment companies through revenue sharing, soft dollar, and other practices with little visibility and even less familiarity, how reasonable is our expectation that investors should know when to exit?" He further stated that he found it "striking" that

> investors do not receive a uniform statement explicitly identifying the dollars they paid in the past year. Banks offer their customers a statement of fees; home mortgage and car lenders offer a statement of fees . . . How is it that there is no comparable requirement for statements on the individualized costs for [investment companies]?

Director Birdthistle also focused on shareholder engagement in the proxy process. He shared his concern "that investors who are interested in using their voice indirectly through the votes of funds in which they invest may not have sufficient information about how portfolio shares are voted." He expressed his support for "the staff's consideration of comments on proposals to require streamlined shareholder reports, to amend prospectus fee and expense disclosure, and to enhance the information funds report about their proxy votes."

Director Birdthistle discussed the fiduciary duties that fund advisers owe the funds they manage. He observed that no plaintiff has yet won a case for breach of an adviser's fiduciary duty brought under Section 36(b) of the 1940 Act. Therefore, he posited, "if no adviser can ever lose one – and none has, so far – one wonders whether the duty enacted in the statute is truly being honored."

Regulatory Priorities Corner

The following brief update exemplifies certain trends and areas of current focus of relevant regulatory authorities.

SEC Division of Examinations Announces 2022 Examination Priorities

On March 30, 2022, the SEC's Division of Examinations published its 2022 Examination Priorities, which include the following:

Registered Investment Companies, Including Mutual Funds and ETFs

- Perennial areas, including disclosures to investors, accuracy of reporting to the SEC, compliance with the new rules and exemptive orders (including ETF rules and exemptive orders for non-transparent, actively managed ETFs, and custom baskets).
- Whether funds' liquidity risk management programs are reasonably designed to assess and manage the funds' liquidity risk, and the implementation of required liquidity classifications, including firms' oversight of third-party service providers.
- Money market funds, which will be reviewed for compliance with applicable requirements, including stress-testing, website disclosures, and board oversight.
- Mutual funds investing in private funds to assess risk disclosure and valuation issues.
- Certain fund practices, including a focus on advisory fee waivers to assess the sustainability of services for firms that provide such waivers, and trading activities of portfolio managers that may be designed to inflate fund performance.

Environmental, Social, And Governance (ESG) Investing

- The accuracy of disclosures regarding ESG investing approaches and whether investment advisers have adopted and implemented policies and procedures to prevent violations of the federal securities laws in connection with their ESG-related disclosures (including review of their portfolio management processes and practices).
- Voting client securities in accordance with proxy voting policies and procedures, including whether the votes align with ESG-related disclosures and mandates.

Information Security and Operational Resiliency

- Safeguarding customer accounts and preventing account intrusions, including verifying an investor's identity to prevent unauthorized account access.
- Overseeing vendors and service providers.
- Addressing malicious email activities, such as phishing or account intrusions.
- Responding to incidents, including those related to ransomware attacks.
- Identifying and detecting red flags related to identity theft.
- Managing operational risk as a result of a dispersed workforce in a work-from-home environment.
- Reviewing registrants' business continuity and disaster recovery plans, with particular focus on the impact of climate risk and substantial disruptions to normal business operations.

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Emerging Technologies and Crypto-Assets

- For examinations of mutual funds and ETFs offering exposure to crypto-assets, assessing compliance, liquidity, and operational controls around portfolio management and market risk.

- Routinely reviewing, updating, and enhancing compliance practices (*e.g.*, crypto-asset wallet reviews, custody practices, anti-money laundering reviews, and valuation procedures), risk disclosures, and operational resiliency practices.

Upcoming Compliance Dates

The following is a reminder of the upcoming compliance dates of significant SEC rulemakings.

August 1, 2022 – Closed-End Fund Inline XBRL Format Requirements. Closed-end funds that are eligible to file a short-form Form N-2 will be required to comply with Inline XBRL format requirements beginning August 1, 2022. All other closed-end funds must comply beginning February 1, 2023. See Ropes & Gray's April 27, 2020 Alert.

August 19, 2022 – Funds' Use of Derivatives. Rule 18f-4's effective date was February 19, 2021. The adopting release provides for an 18-month transition period following the rule's effective date (*i.e.*, until August 19, 2022) for funds to prepare to come into compliance with Rule 18f-4. In addition, on that date, Release 10666 will be rescinded and related no-action letters and other staff guidance (or portions thereof) will be withdrawn. On August 19, 2022, the SEC also will rescind the exemptive orders provided to leveraged/inverse ETFs, which will be permitted to rely on Rule 6c-11, as amended by the Rule 18f-4 adopting release. See Ropes & Gray's November 6, 2020 Alert.

September 8, 2022 – Good Faith Determinations of Fair Value. The effective date for Rules 2a-5 and 31a-4 was March 8, 2021. The compliance date is September 8, 2022. Funds have the option of complying with the Rules before the compliance date and after March 8, 2021. However, the adopting release states that any fund that elects to rely on Rules 2a-5 and 31a-4 before the compliance date may rely only on those rules, and may not also rely on other SEC guidance and staff letters and other guidance that will be withdrawn or rescinded on the compliance date. See Ropes & Gray's December 9, 2020 Alert.

FINRA Solicits Comment on Effective Sales Practices and Rule Enhancements with Respect to Complex Products and Options

On March 9, 2022, the Financial Industry Regulatory Authority ("FINRA") issued Regulatory Notice 22-08 (the "Notice"), which is premised on the significant increase in access by self-directed retail investors to "complex products" and options. The Notice signals a potentially sweeping change in FINRA's regulatory approach to self-directed investing and may well generate substantial public comment from both investors and industry participants.

Background. The Notice states that the "number of accounts trading in complex products and options has increased significantly in recent years." It notes that there "is currently no standard definition of a 'complex product'" and that, instead, FINRA construes the term flexibly to avoid a definition that does not reflect the evolution of financial products and technology. Nonetheless, the Notice emphasizes, FINRA has already described characteristics that make a product "complex," including product features that "may make it difficult for a retail investor to understand the essential characteristics of the product and its risks (including the payout structure and how the product may perform in different market and economic conditions)," and that, in Regulatory Notice 12-03, FINRA provided "numerous examples of the types of retail-oriented products that would be considered complex."[1]

[1] The Notices states that, in addition to previously identified complex products, the following are also deemed complex products by FINRA: (i) mutual funds and ETFs that offer strategies employing cryptocurrency futures, (ii) interval funds and or tender-offer funds that provide limited liquidity to investors and (iii) defined outcome ETFs that offer structured retail product-type features, such

With respect to options, the Notice states that, like transactions in complex products, buying or selling options can be risky for retail investors who trade options "without understanding their vocabulary, strategies and risks" and that options and options strategies "are routinely being developed and some risks are not apparent until there has been significant experience with them." The Notice observes that, like the concerns associated with complex products, concerns regarding options trading "may be heightened when retail investors make self-directed decisions through online platforms without the assistance of a financial professional."

Request for Comment. In explaining the rationale for the request for comment, the Notice makes specific reference to the adoption of Regulation Best Interest and recent Commission statements regarding complex products, as well as a sharper focus on complex products by the SEC exam staff. In view of this focus and the heightened trading in complex products and options by retail investors, the Notice solicits comment on (i) effective practices that FINRA members have developed for managing the risks complex products and options raise, particularly those accessible to self-directed retail investors and (ii) whether the current regulatory framework adequately addresses the concerns that complex products and options raise.

For example, with respect to complex products, the Notice solicits responses to the following questions:

- How members categorize products as "complex."
- What practices have firms developed that have proved effective with respect to supervising sales and trading of complex products, including in self-directed accounts?
- Have members implemented and, if so, found effective, the following practices:
    - Enhanced account approval processes before an account may trade in complex products?
    - Requirements that a customer complete training or a learning course before approval to trade in certain complex products?
    - Additional disclosures or educational materials on complex products?
    - Required customer attestations regarding knowledge and experience?
    - Restrictions or limitations on retail customer access to complex products (*e.g.*, limiting access to high-net worth or other categories of customers)?
- What specific supervisory practices that enhance members' review of a customer's transactions in complex products, including transactions in self-directed accounts, have proved effective?
- How do members assess financial professionals' understanding of specific products?
- Should different or additional requirements be applied with respect to complex products?
- Should additional supervisory obligations apply with respect to complex products and retail customers, such as requiring members to implement:

as exposure to the performance of a market index, but with downside protection and an upside cap on potential gains over a specified period (typically one year).

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- Heightened supervision for recommendations of complex products to retail customers?
- Policies and procedures to help ensure that retail customers possess the requisite understanding of the complex product and its risk prior to allowing such investment, including in self-directed accounts?

Comment Deadline. The Notice states that comments must be received by FINRA no later than May 9, 2022.

Additional Ropes & Gray Alerts and Podcasts Since Our December–January Update

These Alerts and podcasts are in addition to the Alerts listed at the beginning of this Update.

Secondaries Sophistication Drives a Surge in Activity
April 8, 2022
This is the April 2022 edition of *PErspectives* – our periodic publication featuring news, trends and legal developments in the private equity industry. In this issue, we examined the forces behind the booming secondaries deal activity, which had a record-setting 2021 and is likely to continue its ascent for the rest of 2022. We also delved into the regulatory and geopolitical headwinds facing the market.

Podcast: A Primer on Fund Recapitalizations
March 30, 2022
In this Ropes & Gray podcast, asset management and tax attorneys Isabel Dische, Lindsey Goldstein, Dan Kolb, Alex Chauvin and Jessica Marlin discussed fund recapitalization transactions, including what these deals are and why a fund and its limited partners may want to pursue a fund recap. This episode also touched upon typical structures for these deals and certain considerations fund sponsors will want to keep in mind, as well as how to reduce deal execution risk.

Cryptocurrency and 401(k) Plans: DOL Implores Fiduciaries to Exercise Extreme Care
March 15, 2022
On March 11, 2022, the U.S. Department of Labor (the "DOL") published Compliance Assistance Release No. 2022-01 (CAR 2022-01) to provide guidance for 401(k) plan fiduciaries who are considering plan investments in cryptocurrencies. The strongly worded statement reveals the agency's heightened level of concern surrounding cryptocurrency as plan investments, with the DOL cautioning fiduciaries to "exercise extreme care" before they consider adding a cryptocurrency option to a 401(k) plan lineup for plan participants. Although CAR 2022-01 was released just one day after President Biden signed an Executive Order outlining a whole-government strategy to ensure responsible innovation in digital assets, the use of cryptocurrency in 401(k) plan lineups has been on the DOL's radar at least since the summer of 2021. At that time, there were statements from the Acting Assistant Secretary for the DOL's Employee Benefits Security Administration that the agency viewed the use of cryptocurrencies in the retirement plan context as a "very troubling" development given its high volatility and limited transparency.

U.S. Executive Order on the Development of Digital Assets
March 10, 2022
On March 9, 2022, President Biden signed an Executive Order entitled "Executive Order on Ensuring Responsible Development of Digital Assets" (the "Executive Order") that outlines a whole-government strategy to ensure responsible innovation in digital assets, including cryptocurrencies. The Executive Order identifies six principal policy objectives regarding digital assets. The Executive Order further emphasizes the need to explore innovations surrounding digital assets in order to drive U.S. technological competitiveness, while identifying and addressing the global and domestic risks posed by digital asset technology. The Executive Order is also notable in that it directs extensive interagency consultation and cooperation with respect to all of the policy objectives outlined in it, including cooperation with regulatory bodies outside of the executive branch such as the SEC and the Commodity Futures Trading Commission.

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Additionally, the Executive Order directs the creation of a framework for interagency international engagement on these issues.

Podcast: Recent Developments on the Use of MAC Clauses in Secondary Transactions
March 3, 2022
In this Ropes & Gray podcast, asset management partners Emily Brown, Isabel Dische, Adam Dobson and Vincent Ip, and litigation & enforcement partner Martin Crisp, discussed recent trends in the usage of material adverse change (or MAC) clauses and "ordinary course" operating covenants in secondary transactions, and provided some context on how these provisions may be interpreted in light of recent events in Ukraine.

SEC Settles Charges against BlockFi Lending
February 23, 2022
On February 14, 2022, in one of the largest penalties ever imposed in the crypto space, the SEC settled charges against BlockFi Lending LLC ("BlockFi"). The SEC charged BlockFi with failing to register as an "investment company" and failing to register its retail crypto lending product, BlockFi Interest Accounts ("BIAs"), as securities. The SEC also charged BlockFi with making materially false and misleading statements concerning the risks associated with BIAs. Although this was the SEC's first enforcement action against a crypto lending platform, the SEC's activity in the crypto space is intensifying significantly.

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If you would like to learn more about the developments discussed in this Update, please contact the Ropes & Gray attorney with whom you regularly work or any member of the Ropes & Gray Asset Management group listed below.

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