Investment Management Regulatory Update

July 31, 2020

COVID-19 Update

Please refer to Davis Polk's "**Coronavirus Updates**" webpage for content related to the outbreak.

Rules and Regulations

SEC Proposes Amendments to Update Form 13F for Institutional Investment Managers

In a July 10, 2020 release ("**Release**"), the Securities and Exchange Commission ("**SEC**") proposed certain amendments to Rule 13f-1 under the Securities Exchange Act of 1934 ("**Exchange Act**") and Form 13F, including an increase in the reporting threshold for institutional investment managers from $100 million to $3.5 billion. According to the Release, the SEC believes that this new threshold better reflects the expanded U.S. equities market and will help further the purpose of the rule.

Section 13(f) and Rule 13f-1

Section 13(f) of the Exchange Act and Rule 13f-1 thereunder require an institutional investment manager to file a report on Form 13F if the manager exercises investment discretion over accounts that contain certain equity securities ("**13(f) securities**") with an aggregate fair market value on the last trading day of any month of any calendar year of at least $100 million. According to the Release, the purposes of the reporting requirement are to: (i) create a "central repository of historical and current data about the investment activities of institutional investment managers," (ii) improve available data about the holdings of institutional investment managers "and thus facilitate consideration of the influence and impact of institutional investment managers on the securities markets and the public policy implications of that influence" and (iii) "increase investor confidence in the integrity of the U.S. securities markets."

Under Section 13(f), the SEC has rulemaking authority to adjust the format and frequency of the reports, the nature of the disclosures in the reports, and the reporting threshold "of at least $100,000,000 or such lesser amount." The Release noted that the 1975 Amendments Senate Report stated that the SEC "would 'have authority to raise or lower' the threshold" and listed out certain considerations that the SEC should consider when adjusting the threshold, including the burden of reporting and the informational value provided by the disclosure.

Proposed Amendments

The Release noted that since the adoption of Rule 13f-1 in 1978, the securities market has grown exponentially from $1.1 trillion in 1979 to $35.6 trillion in 2019. According to the Release, 5,089 managers are currently required to file Form 13F, many of whom are small managers – the compliance burden on such managers is great while the information value received from requiring them to file is limited. Therefore, as stated in the Release, the SEC is proposing to increase the reporting threshold from $100 million to $3.5 billion, which reflects the growth in the US equities market since 1975 and would retain disclosure of "90.8 percent of the dollar value of the Form 13F holdings data currently reported while relieving the reporting burdens from approximately [. . .] 89.2 percent of all current filers." According to the Release, the SEC intends to have its staff reevaluate the threshold every five years and make a change, if necessary.

In addition to increasing the threshold, the proposed amendments would also:

- eliminate the omission threshold which allows managers to omit holdings of fewer than 10,000 shares and less than $200,000 aggregate fair market value;
- require additional identifying information to be reported on Form 13F, including a manager's CRD number and SEC filing number, if any;
- make technical amendments consistent with the eXtensible Markup Language ("**XML**") format; and
- require managers seeking confidential treatment to demonstrate that "the information is both customarily and actually kept private by the manager and to show how the release of this information could cause harm to the manager."

Commissioner Allison Herren Lee's Dissenting Opinion

In a July 10, 2020 statement, SEC Commissioner Allison Herren Lee expressed concerns with the proposed amendments, arguing that: (i) the proposal decreases transparency and reduces the SEC's and the public's access to market information, (ii) the proposal fails to provide a thorough economic analysis of the proposed amendments and overestimates the compliance costs of the current filing requirement; and (iii) there is uncertainty as to whether the SEC has the authority to increase the reporting threshold, suggesting that the text of Section 13(f) gives the SEC the authority to lower the threshold but not to increase it.

- **See a copy of the Release**
- **See a copy of Commissioner Lee's statement**

SEC Adopts Amendments to Exemptive Application Procedures

On July 6, 2020, the SEC issued a release (the "**Release**") adopting amendments to Rule 0-5 (the "**Final Rule**") under the Investment Company Act of 1940, as amended ("**Investment Company Act**"), which sets forth the procedures for applications for exemptive relief. These amendments were originally proposed to the public on October 18, 2019, with a 30-day comment period (the "**Proposed Rule**"). The amendments will, among other changes: (i) establish an expedited review process for exemptive relief applications that are substantially identical to recent precedents, (ii) implement a new rule to deem an application withdrawn if the applicant does not reply to comments within 120 days, and (iii) implement an internal timeframe for applications that would not qualify for the new expedited process. In the press release announcing the Final Rule, Chairman Clayton noted that the amendments will "modernize and streamline this process, resulting in improved transparency, reduced costs, and a more efficient use of [the SEC] staff's resources." The new procedure will be effective 270 days following their publication in the Federal Register.

Background

Certain provisions of the Investment Company Act empower the SEC to issue orders granting exemptive relief from certain requirements of the Investment Company Act. For example, Section 6(c) gives the SEC authority to "conditionally or unconditionally exempt any person, security, or transaction . . . from any provision or provisions of [the Investment Company Act] or of any rule or regulation thereunder, if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of [the Investment Company Act]."

According to the Release, the application process "has been a significant and valuable tool in the evolution of the investment management industry, and sometimes is the origin of new rules under the [Investment Company] Act." The Release also noted that applicants have "sought relief to implement innovative features or create new types of funds that do not fit within the regulatory confines" of the Investment Company Act, such as exchange-traded funds. However, according to the Release, applicants have expressed concern regarding the time required to obtain relief for both "routine and novel applications." The SEC has therefore adopted the Final Rule, which is intended to make the application process more efficient and effective. The Release noted that for applications received on or after June 1, 2019, the SEC staff has implemented a new target of providing comments "on both initial applications and amendments within 90 days."

Expedited Review

The amendments to Rule 0-5 "establish an expedited review procedure for applications that are substantially identical to recent precedent." The Release identified various potential benefits of the amendments, including the SEC's ability to grant relief more quickly and to "devote additional resources to the review of more novel requests," as well as a less expensive application process for applicants. According to the Release, under Rule 0-5(d), an applicant may request expedited review if the application is "substantially identical" to two other applications for which an order granting relief has been issued within three years of the application's initial filing.

Substantially Identical Standard. Substantially identical applications would be defined as those requesting relief from the same sections of the Investment Company Act and rules thereunder, "containing identical terms and conditions, and differing only with respect to factual differences that are not material to the relief requested." The Release noted that the substantially identical requirement "would help to ensure that applicants use the [expedited] procedure only when they do not need to modify the terms and conditions of the precedent applications and are not raising new issues for the [SEC] to consider." While some commentators suggested broadening the "substantially identical" standard or modifying the standard, the Final Rule is largely the same as the Proposed Rule, citing that adjusting the standard to allow extensive differences "would frustrate the objective of creating a quick review process with increased certainty." Similarly, some commentators suggested allowing applicants to combine portions of different prior applications. The Final Rule does not allow this style of "mix and match" precedent applications, since in the SEC staff's experience, reviewing applications with different lines of precedents would require deeper analysis and has previously "resulted in a significant number of comments, rendering such applications inconsistent with the approach to, and purpose underlying, the expedited process." The SEC declined creating a standard template for routine or more frequently raised applications, because it believes "when a line of applications becomes so routine that standard terms and conditions could be articulated, a better approach would be to consider codifying such relief in a new rule under the [Investment Company] Act that would make applications unnecessary."

The Release indicated that "[b]ased on the [SEC] staff's experience, applications that involve the same types of entities, request the same relief, and are subject to the same terms and conditions as precedent," with minor factual differences, typically fit the “substantially identical” standard. In order to fit the standard by having “identical” terms and conditions, not only must the substance be the same as that of the precedent, but also the wording must be the same.

Look Back Period. The Proposed Rule required the precedents for expedited review to be issued within the last two years prior to the filing of the application in question, to ensure precedents are relatively recent. After receiving comments on this proposed two-year lookback period, the SEC revised the Final Rule to allow for a three-year look back period. While some commentators believed the two-year lookback period was too long given “the rate of change in the investment management industry,” the majority of commentators believed that it was too short. The SEC reasoned that extending the lookback period to five years, as some commentators suggested, would frustrate the goal of creating a quicker review period since it would require the SEC staff to review all of the applications approved after the precedent to ensure that the precedent “includes up to date terms and conditions, and is otherwise consistent with the [SEC’s] current policies.” In the Final Rule, the SEC extended the lookback period to three years “to provide additional flexibility” and is requiring the applicants to explain in their cover letter why they chose the precedents they are using. Specifically, if there are more recent precedents, an applicant must explain why the chosen precedent is more appropriate. The purpose of this requirement is to ensure applicants “only use older precedent when there is good reason for doing so.”

Lines of Applications that Might Not Qualify for Expedited Review. In the Final Rule, the SEC decided not to explicitly exclude any particular type of application from expedited review. In the Proposed Rule, the SEC stated that certain types of applications, including those filed under sections 2(a)(9), 3(b)(2), 6(b), 9(c), and 26(c) of the Investment Company Act, are unlikely to qualify for expedited review because they are too fact-specific. After receiving comments suggesting the rule explicitly exclude different combinations of the types of applications, the SEC decided not to explicitly exclude any type from expedited review. The SEC continues to believe, however, that certain lines of application will generally not satisfy the standard because while the terms of conditions of an application may be substantially identical,” the SEC staff looks at particular facts and circumstances outlined in the application to evaluate whether the requested relief meets the applicable standard.” The SEC decided not to explicitly exclude these types of applications to maintain flexibility that circumstances may arise in which those applications can satisfy the “substantially identical” standard.

Additional Information Required for Expedited Review. According to the Release, Rule 0-5(e) requires an application submitted for expedited review to include the following additional information: (i) a notation on the cover page of the application prominently stating “EXPEDITED REVIEW REQUESTED UNDER 17 CFR 270.0-5(d)”; (ii) exhibits with marked copies of the application showing changes from the two precedents identified as substantially identical; and (iii) a cover letter. The cover letter must identify the two precedents, explain why the applicant chose those two particular precedents, and if more recent applications of the same type have been approved, why the chosen precedents are more appropriate. The cover letter must also certify that the applicant “believes the application meets the requirements of [the rule] and that the marked copies . . . are complete and accurate.” The Release stated that these additional requirements are necessary to verify whether the new application is substantially identical to both precedents and so the applicant can certify that the application is complete and accurate.

Expedited Review Timeframe. The Release stated that, under Rule 0-5(f), a notice for an application for expedited review would be issued no later than 45 days from the date of filing, “unless the applicant is notified that (i) the application is not eligible for expedited review because it does not meet the criteria in Rule 0-5(d), or (ii) additional time is necessary for appropriate consideration of the application.” The Release provided examples of when further consideration may be required, including: “cases where the [SEC] is considering a change in policy that would make the requested relief, or its terms and conditions, no longer appropriate” and “cases where [SEC staff] is investigating potential violations of [f]ederal securities laws that may be relevant to the request for relief.” The SEC also amended 17 CFR 200.30-5 to delegate to the Investment Management Division Director the authority to notify an applicant under Rule 0-5(f)(1)(ii) that an application is not eligible for expedited review under Rule 0-5.

According to the Release, Rule 0-5(f) imposes conditions on the operation of the 45-day period. The Proposed Rule suggested that the 45-day period would restart upon the filing of any amendment that the SEC or its staff did not solicit. Upon receiving comments suggesting that the SEC instead establish a 14-day pause for immaterial unsolicited amendments and a 45-day period only for material unsolicited amendments, the SEC adopted the Final Rule with a 30-day timeline for SEC staff to review both material and immaterial unsolicited amendments. This means that the 45-day review period would be paused upon the filing of any unsolicited amendment for 30 days (although SEC staff may act before the end of the additional 30-day period "if the unsolicited amendment only encompasses minor changes"). In addition, the 45-day period would stop running upon: (i) any comment on the application by SEC staff, and would resume running on the fourteenth day after the applicant files an amended application responsive to such request; or (ii) any irregular closure of the SEC's Washington, D.C. office to the public for normal business hours, and would resume upon the reopening of the office.

According to the Release, under Rule 0-5(f), if an applicant does not file an amendment responsive to SEC staff's request within 30 days of receiving such request, including the required marked copy and certification discussed above, the application would be deemed withdrawn and such withdrawal would be without prejudice.

Standard Review

The SEC has adopted a new rule to provide a timeframe for all other applications filed under Rule 0-5 that do not qualify for the expedited review process, in order to "provide applicants with added transparency regarding the review of applications." According to the Release, under paragraph (a) of the rule, SEC staff "should take action" on applications subject to standard review within 90 days of the initial filing and each of the first three amendments thereto, and within 60 days of any subsequent amendment. Taking "action" on an application or amendment could consist of: "(i) issuing a notice of application; (ii) providing the applicants with comments; or (iii) informing the applicants that the application will be forwarded to the [SEC], in which case the application is no longer subject to paragraph (a) of the rule." The Release stated that SEC staff may also grant 60-day extensions and applicants should be notified of such extensions. In addition, the Release noted that if SEC staff does not support the requested relief, it typically notifies applicants, giving applicants an opportunity to withdraw an application before a recommendation to deny relief is made. This new rule is moderately different from the proposed rule, as the SEC addressed some of the comments that the application period was too long, while maintaining "flexibility for situations where more time is needed for appropriate consideration."

According to the Release, the SEC also amended Rule 0-5 to deem an application withdrawn if an applicant does not respond in writing to SEC staff comments within 120 days of the request. The Release stated that this procedure will allow the SEC to maintain "a clear record of pending applications, as well as provide the public, including potential new applicants, with a better sense of the applications that the [SEC] is actively considering at any given time." In addition, the Release noted that such withdrawals would be without prejudice.

Release of Comments

According to the Release, the SEC had announced in its release for the Proposed Rule that it intended to publicly disseminate SEC staff comments on applications and responses to those comments in an effort to "improve the transparency of the application process." Most commentators recommended against public dissemination of comments expressing many concerns such as "thwart[ing] open dialogue between applicants and the [SEC] staff," increasing confidential treatment requests which would increase the administrative burden, and applicants' increased use of oral communication with SEC staff, in an effort to avoid dissemination of information. Additionally, commentators did not believe this would provide much utility to investors, and could be confusing to the public. Some commentators supported public dissemination of comments and responses. The Commission plans to continue to consider publicly disseminating staff comments and responses to those comments, but will not disseminate that information at this time.

- **See a copy of Final Rule Release**
- **See a copy of the Press Release**

Industry Update

SEC Issues Supplemental Guidance Concerning Proxy Voting Responsibilities of Investment Advisers

On July 22, 2020, the SEC issued a release with guidance that supplements its prior guidance regarding the proxy voting responsibilities of investment advisers under the Investment Advisers Act of 1940, as amended ("**Advisers Act**"). The SEC published this guidance in conjunction with amendments to the rules governing proxy solicitations under the Exchange Act, which were also referenced in the release. The SEC expects that the amendments will improve the "mix of information that is available to investors" by providing issuers with access to proxy advisory firm recommendations within a timeframe in which such issuers can provide shareholders with additional information that may be material to a voting decision. As such, the guidance is meant to supplement the prior guidance to assist investment advisers in how to consider this additional information in light of their proxy voting responsibilities. Davis Polk has published a **Client Alert** discussing the guidance.

- **See a copy of guidance**

Litigation

SEC Settles with Investment Advisers for Allegedly Causing Managed Funds to Exceed Investment Company Act Ownership Limits

On July 2, 2020, the SEC issued an order (the "**Order**") instituting and settling cease-and-desist proceedings against two affiliated registered investment advisers managing, collectively, approximately $446 billion in assets as of September 2019.

Sections 12(d)(1)(A) and (F) of the Investment Company Act impose certain limitations on the amount of interests that an investment company may acquire in any particular investment company or other investment companies in the aggregate. According to the Order, the adviser had policies and procedures intended to prevent violations of these provisions of the Investment Company Act, but failed to implement a pre-trade screening process to avoid violations. The SEC alleges that, from December 2014 to November 2015, one of the advisers caused certain managed funds to acquire interests in three ETFs that exceeded the Investment Company Act's ownership limits.

The adviser's compliance department allegedly discovered these breaches on November 24, 2015, and caused the funds to reduce their positions in the three ETFs beginning on November 25, 2015. The managed funds realized losses of approximately $2.2 million in sales of one of the ETFs, and gains of approximately $3.7 and $4.7 million in sales of the other two ETFs.

The Order states that the adviser's trade error policy provided that it would reimburse for client losses caused by trade errors, or that it could correct trade errors under an "alternative method" if granted approval of designated officers. According to the SEC, the adviser decided that because the managed funds had realized gains on the sales of the two ETFs that breached the ownership limits, and losses on the sales of the third ETF, it would not reimburse the funds for the losses realized. The SEC alleges that this decision created a conflict of interest between the adviser and the managed funds, and that the adviser did not disclose this conflict to the funds' board. The SEC also alleges that the adviser did not follow the procedure for the "alternative method" of correcting trade errors, nor did the adviser obtain the required approvals to do so. The adviser allegedly disclosed the trade error to the funds' board first on June 30, 2016, but failed to disclose that it would not be reimbursing the funds for the losses. It eventually reimbursed the funds for the losses, with interest, in February 2018, after the commencement of the SEC's investigation.

The SEC also alleges that, from February 2015 to September 2016, six funds managed by the other, affiliated adviser acquired shares of two ETFs in excess of the Investment Company Act's limits.

The SEC alleges that, by the conduct described above, the advisers caused certain of their managed funds to violate the Investment Company Act ownership limit restrictions. The SEC also alleges that one of the advisers willfully violated Section 206(2) of the Advisers Act, Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, and caused the funds to violate Rule 38a-1(a) under the Investment Companies Act. It agreed to cease and desist from future violations, to be censured, and to pay a civil money penalty of $250,000; the other, affiliated adviser agreed to cease and desist from future violations, and to pay a civil money penalty of $75,000.

- **See a copy of the Order**

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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