



Investment Management Update

July 2019

SEC Proposes Updates to Rules Governing CEFs

Key Notes:

- The SEC recently proposed wide-ranging reforms that modify the rules governing registration, communications and offering processes for business development companies and closed-end funds, including interval funds.
- The reforms for closed-end funds were dictated by the Economic Growth, Regulatory Relief, and Consumer Protection Act enacted in 2018.
- The reforms are designed to facilitate and simplify capital raising activities by seasoned closed-end funds and encourage the formation of new closed-end funds.

On March 20, 2019, the Securities and Exchange Commission (SEC) proposed rules that would modify the registration, communication and offering processes for certain closed-end funds (CEFs), including interval funds, under the Securities Act of 1933, as amended (Securities Act), the Securities Exchange Act of 1934, as amended (Exchange Act) and the Investment Company Act of 1940, as amended (1940 Act). The proposed rules would, among other things, allow certain CEFs, including interval funds and business development companies (BDCs), to utilize securities offering reforms previously made available to other operating companies and permit broader communications with shareholders.

In a [prior alert](#), we discussed the proposed rules as they relate to BDCs. This alert examines the impact of the proposed rules on CEFs, including interval funds.

Background

In 2005, the SEC adopted securities offering reforms and created new classes of issuers that had significant public float and were current and timely in their filing of periodic reports in an effort to modernize the securities offering and communication processes and to enable these issuers to more efficiently access the capital markets. As part of the securities offering reform rules, the SEC designated investment companies, including CEFs, as “ineligible issuers,” which had the effect of specifically excluding these entities from the scope of the reforms.

Proposed Rules

Two laws enacted in 2018 precipitated the proposed rulemaking: the Small Business Credit Availability Act (BDC Act) and the Economic Growth, Regulatory Relief, and Consumer Protection Act (CEF Act). The BDC Act directed the SEC to initiate rulemaking to allow BDCs to use the same offering rules as public operating companies. The SEC determined to apply the rules it proposed for BDCs to CEFs, as discussed further herein.

The CEF Act sought to update the rules and regulations governing CEFs. It instructed the SEC to promulgate rules that would allow any registered CEF, including one that operates as an interval fund, to take advantage of the securities offering reforms made available to other operating companies as part of the 2005 rulemaking.

The proposed rules, among other things, would allow CEFs to:

- Use a short-form registration statement to sell securities “off the shelf” more quickly and efficiently in response to market opportunities.
- Qualify as well-known seasoned issuers (WKSIs) under Rule 405 of the Securities Act.
- Satisfy final prospectus delivery requirements using the same method as operating companies.
- Expand the ability to communicate with shareholders through the use of “free writing prospectuses.”
- Be able to rely on safe harbors relating to the use of regularly released factual and forward-looking information, including “tombstone ads.”

In addition, CEFs would be required to report certain material events on Form 8-K, consistent with requirements imposed on operating companies and BDCs. Further, the proposed rules would introduce two new 8-K item requirements tailored to investment companies.

Finally, the proposed rules would allow interval funds to pay SEC registration fees using the same methods that open-end mutual funds and exchange-traded funds (ETFs) currently employ.

Summary of Offering-Related Reforms

Short-Form Registration Statements on Form N-2

The proposed rules would permit a CEF that is a “seasoned fund,” as defined in the proposed rules (Seasoned CEF), to use the more flexible registration process currently available to “seasoned issuers,” a category of issuer designated in the 2005 securities offering reform. In order to be considered a Seasoned CEF, a CEF must have at least \$75 million in public float held by non-affiliates and must meet the registrant and transaction requirements of Form S-3, which require that the CEF be current and timely in its reporting requirements under the 1940 Act.

The proposed rules would require Seasoned CEFs to incorporate certain past and future Exchange Act reports, such as quarterly and annual reports, by reference into their registration statements, allowing them to reduce the expenses associated with the filing of post-effective

amendments to their registration statements. Certain reports will be “forward incorporated by reference,” meaning that reports that have not yet been filed will be deemed to be incorporated by reference into a registration statement that continues to be used after future reports are filed. Specifically, a Seasoned CEF relying on the short-form registration instruction would be required to:

- specifically incorporate by reference its most recent annual report and all other reports filed since the end of the fiscal year covered by the annual report (backward incorporation by reference); and
- state that all Exchange Act reports filed prior to the termination of the offering shall be deemed to be incorporated by reference (forward incorporation by reference).

A Seasoned CEF would also be permitted to incorporate by reference Exchange Act reports to satisfy disclosure requirements in its prospectus or SAI.

Well-Known Seasoned Issuers

The proposed rules would permit a CEF to qualify as a WKSI, which provides the CEF flexibility to take advantage of market windows, structure terms of securities on a real-time basis to accommodate investor demand, and determine or change the plan of distribution in response to changing market conditions. To qualify as a WKSI, a CEF must be a Seasoned CEF and generally must have at least \$700 million in public float held by non-affiliates. This proposal would allow a CEF that qualifies as a WKSI to register amounts of different types or classes of securities on an automatic shelf registration statement, which would be effective immediately upon filing. To implement this change, the proposed rules would add a new general instruction to Form N-2 that would permit CEFs that qualify as WKSIs to file automatic shelf registration statements on Form N-2.

Moreover, a WKSI is permitted to communicate at any time, through a permitted free writing prospectus, without violating the “gun jumping” provisions of the Securities Act.

Prospectus Supplements

The SEC also proposed modifications to the process for filing prospectus supplements. Presently, operating companies depend solely on Securities Act Rule 424, whereas investment companies rely solely upon Securities Act Rule 497. Rule 424 provides an operating company additional flexibility by only requiring an issuer to file a prospectus if it makes substantive changes from or additions to a previously filed prospectus, whereas Rule 497 requires a fund to file every prospectus that varies from any previously filed prospectus. The proposed rules would allow a CEF to file any type of prospectus enumerated under Rule 424(b) to update or include information omitted from a prospectus or in connection with a shelf takedown. Moreover, the proposed rules would amend Rule 497 to provide that Rule 424 would be the exclusive rule for CEFs to file prospectus supplements, with the exception of advertisements deemed to be a prospectus under Securities Act Rule 482.

Omitting Information from a Base Prospectus

The proposed rules would allow a shelf registration statement filed by a Seasoned CEF to omit the plan of distribution and certain other information regarding whether the registration statement is for a primary offering or on behalf of selling security holders. In addition, Seasoned CEFs that register securities for selling security holders would be able to omit the selling security holders' identities and the amount of securities to be registered from the registration statement, as operating companies are permitted to do today.

Final Prospectus Delivery Reforms

The Securities Act requires registrants to deliver to each investor a final prospectus prior to or concurrent with the sale of a security. Furthermore, the Securities Act prohibits a written communication that offers a security for sale or confirms the sale of a security unless a final prospectus is given at the same time. Securities Act Rules 172 and 173 permit operating companies to satisfy prospectus delivery requirements by filing a final prospectus under Securities Act Rule 424. The proposed rules would allow a CEF to

satisfy the prospectus delivery requirements by filing its final prospectus with the SEC.

Communication Reforms

Offering Communications

The proposed rules also include a number of changes in the ways CEFs can communicate with their shareholders and provide for greater regulatory certainty by allowing them to rely on safe harbors available to operating company issuers. As noted previously, CEFs were designated "ineligible issuers" as part of the 2005 securities offering reform rulemaking and were, therefore, excluded from a number of provisions designed to enhance the ability of operating company issuers to better communicate with their shareholders. The proposed rules would amend the current prohibitions to allow CEFs to:

- Rely on Securities Act Rule 134's safe harbor relating to the publishing of certain factual information about the issuer or offering, including in tombstone ads.
- Qualify for the communication safe harbor provided by Securities Act Rule 163A, which grants issuers a bright-line time period, ending 30 days prior to the filing of a registration statement, to communicate with the public without such communication being deemed an offer to sell a security.
- Rely on the safe harbors found in Securities Act Rules 168 and 169 relating to the publishing or dissemination of regularly released factual business information.
- Use "free writing prospectuses" under Securities Act Rules 164 and 433.

The proposed rules would also permit Seasoned CEFs to engage at any time in oral or written communications, including through the use of free writing prospectuses.

Broker-Dealer Research Reports

The proposed rules would permit a broker-dealer participating in a distribution of a CEF's common stock and similar securities to rely on the non-exclusive safe harbor found in Securities Act Rule 138, which permits a broker-dealer to publish or distribute research about the CEF's securities that are not part of the offering, if such research is distributed in the regular course of its business.

Other Proposed Rule Amendments

The proposed rules would also amend a number of other rules and regulations impacting CEFs.

New Registration Fee Payment Method for Interval Funds

The proposed rules would require interval funds to pay securities registration fees using the same methods that mutual funds and ETFs use today. Currently, an interval fund is required to pay a registration fee at the time it files a registration statement. The proposed rules would allow an interval fund to pay registration fees based on its net issuance of shares no later than 90 days after the fund's fiscal year end. Similar to mutual funds and ETFs, interval funds would be required to file information about the computation of the registration fee and other information on Form 24F-2 at the time of the fee payment. The proposed rules would also amend Form 24F-2 to require filings be made in a structured data (XML) format rather than the current format in which non-financial EDGAR filings are typically submitted.

XBRL Reporting Requirements

The proposed rules would create new structured data reporting requirements for CEFs. Specifically, a CEF would be required to use Inline XBRL format to include structured cover page information in its registration statement on Form N-2 and to tag certain other information required in a CEF's prospectus.

Use of Form 8-K to Report Material Events

In what is perhaps the most controversial provision in the rulemaking, the proposed rules would require that CEFs file current reports on Form 8-K to report material events in the same manner that operating companies and BDCs currently do. Examples of material events that BDCs have historically reported on Form 8-K include entering into and terminating a material agreement (Items 1.01 and 1.02); incurrence of leverage (Item 2.03); notice of delisting (Item 3.01); sale of unregistered securities (Item 3.02); change in auditors (Item 4.01); appointment and departure of executive officers and members of the board (Item 5.02); amendments to governing documents (Item 5.03); amendments to or

waivers from the issuer's code of ethics (Item 5.05); selective disclosures pursuant to Regulation FD (Item 7.01); other material items (Item 8.01); and the filing of exhibits, such as agreements and press releases (Item 9.01).

The proposed rules would also modify Form 8-K to include two new reportable events (Items 10.01 and 10.02) for all CEF issuers:

- **Item 10.01** – any material change in investment objectives or policies that has not been, and will not be, submitted to shareholders for approval. Item 10.01 would require disclosure regarding the date the change would go into effect as well as a description of the change. No 8-K would need to be filed if the change was reported in a post-effective amendment to the fund's registration statement or a supplement filed pursuant to Securities Act Rule 424.
- **Item 10.02** – any material write-down in the fair value of a significant investment. The level of disclosure required would be consistent with the disclosure of a material impairment by an operating company.

Periodic Reporting Requirements

Seasoned CEFs that register securities using a short-form registration statement would be required to include additional information described below, and all CEFs would be required to provide a new management's discussion of fund's performance (MDFP) section in their annual reports. MDFP sections are currently required for other registered funds (mutual funds and ETFs).

As a consequence of a Seasoned CEF's ability to forward incorporate by reference in its short-form registration statement, the SEC would require these funds to include key information in annual reports that is currently provided in their prospectuses, including information regarding fees and expenses as required by Item 3 of Form N-2, share price data as required by Item 8.5 of Form N-2, and the senior securities table as required by Item 4.3 of Form N-2.

Seasoned CEFs that avail themselves of the exception in Rule 8b-16 under the 1940 Act from having to annually update their prospectuses would need to provide more detailed information in annual reports going forward. Rule 8b-16 permits CEFs that are not currently offering securities

(e.g., listed funds that do not issue additional securities outside of a distribution reinvestment plan) to describe certain changes that would otherwise be disclosed in a prospectus update (e.g., changes to investment policies or material risks) in their annual reports. If the rules are adopted as proposed, going forward, these descriptions would need to provide more context about how these changes would impact the fund.

Finally, a Seasoned CEF that registers securities using a short-form registration statement would be required to disclose in its registration statement or annual report any material unresolved SEC comments. This requirement would mimic the item requirement found in Form 10-K that applies to operating companies and BDCs.

Online Availability of Information Incorporated by Reference

The proposed rules would also revise Form N-2's current general instruction for incorporation by reference to permit Seasoned CEFs to backward and forward incorporate by reference their financial information into their registration statements. The proposed rules would remove the requirement that a CEF deliver to new investors information that it has incorporated by reference into the CEF's prospectus or SAI, and instead would require it to make the incorporated materials readily available and accessible on a website.

Modifications to Supplemental Information Requirements

Securities Act Rule 418 provides that the SEC may request supplemental information, which a registrant should be prepared to promptly provide. The proposed rules would allow Seasoned CEFs to be exempt from the requirement to furnish supplemental information to the SEC pursuant to Securities Act Rule 418(a)(3). Furthermore, the proposed rules would allow Seasoned CEFs to incorporate certain financial information into proxy statements by reference, without delivering these documents to shareholders.

Analysis

While the BDC Act was very prescriptive and became self-effectuating in March 2019, the CEF Act provided the SEC

with more leeway to implement the priorities set forth in the legislation. It sought to reduce regulatory burdens on CEFs, provide parity with operating companies in regard to offering reforms and stem the decline in CEF offerings. Commenters were split as to whether and to what extent these goals were captured in the proposed rules. For example, imposing Form 8-K reporting requirements on CEFs was not part of the CEF Act and arguably goes against the spirit of the legislation. Having said that, the SEC was clearly also concerned about the differing reporting requirements of similar investment products, such as BDCs and CEFs, and this provision would move the needle in that regard.

Commenters also took issue with how Seasoned CEFs and WKSIs are determined, arguing that a different measurement, whether it be NAV or some other value, be used instead of public float in determining which entities could qualify as Seasoned CEFs or WKSIs. In particular, commenters pointed out that since interval funds generally do not list their securities on a national securities exchange, they would not be able to qualify as Seasoned CEFs or WKSIs despite specific language in the CEF Act that instructed the SEC to allow them to do so.

The opposition to these measures, along with a few others, should not diminish the fact that there was very little, if any, opposition to the main thrusts of the rulemaking – streamlining the offering process for CEFs that qualify as Seasoned CEFs and WKSIs and permitting increased communication with the public. Whether these rules will stem the recent decline in CEF offerings is hard to predict, but they would generally benefit a large number of CEFs and, if certain changes are made, the proposed rules could greatly increase the number of CEFs that would benefit.

Next Steps

The comment period for the proposed rules closed on June 12, 2019. A number of questions from the SEC remain for the industry to consider, which could result in changes in the final rules. In addition, many trade groups, law firms and issuers submitted comments, which will likely impact certain items included in the rules.

FOR MORE INFORMATION

For more information, please contact:

Christopher D. Carlson

202.263.4169

Chris.Carlson@ThompsonHine.com

Owen J. Pinkerton

202.263.4144

Owen.Pinkerton@ThompsonHine.com

Brian Doyle-Wenger

614.469.3294

Brian.Doyle-Wenger@ThompsonHine.com

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