SULLIVAN & CROMWELL LLP

S&C Quarterly Investment Management Newsletter

Q4 2023

The S&C Quarterly Investment Management Newsletter highlights key legal and regulatory developments relevant to the investment management industry. For more information on these and other developments, we encourage you to reach out to your regular Sullivan & Cromwell contact.

Highlights

- In this issue we discuss key developments in Q4 2023, including certain rulemaking and legislative activities, SEC Staff guidance and no action letters, disclosure updates, recent litigation and enforcement actions, and updates from the SEC Division of Examinations affecting the investment management industry.
- In our upcoming Q1 2024 issue, we will address key recent developments, including (i) changes to the definitions of "dealer" and "government securities dealer," (ii) updates to market compliance FAQs, which include responses to FAQs related to tailored shareholder reports, (iii) amendments to Form PF to better monitor systemic risk, (iv) proposal to adjust for inflation the dollar threshold used in defining a "qualifying venture capital fund," (v) proposal to require certain investment advisers to apply Anti-Money Laundering and Countering the Financing of Terrorism requirements pursuant to the Bank Secrecy Act, and (vi) enhanced investor protections relating to SPACs, shell companies, and projections.
- See our recent client alerts for more detailed discussions of recently finalized and proposed regulations relevant to the investment management industry, including the SEC's final rules on the reporting of securities loans, beneficial ownership reporting, short sale disclosures, and fund "names" rule, as well as the Department of Labor's proposed rules on fiduciary investment advice. These topics and more are also summarized below.

Recent Legislation and Rulemaking

SEC adopts rules to amend standards for covered clearing agencies for U.S. Treasury Securities. On December 13, the SEC adopted amendments to Exchange Act Rule 17Ad-22(e) that will require: the Fixed Income Clearing Corporation ("FICC"), which is currently the only covered clearing agency in the U.S. Treasury market, to (1) implement standards requiring its members to submit for clearing and settlement all repurchase transactions and certain secondary cash market transactions involving U.S. Treasury securities; (2) implement policies and procedures to calculate, collect and hold margin separately for its proprietary and customer transactions; and (3) implement policies and procedures that are reasonably designed to ensure that it has appropriate means to facilitate access to clearing. Additionally, the rule amended Exchange Act Rule 15c3-3 to permit broker-dealers to include customer margin required and on deposit at FICC as a debit in the customer and PAB (*i.e.*, proprietary accounts of broker-dealers) reserve formulas.

FICC must file with the SEC its own updated rules to implement the final rules on separation of FICC's proprietary and customer margin, broker-dealer customer protection, and access to central clearing by March 16, 2024, and such FICC updated rules must be effective by March 31, 2025. FICC must file its updated rules related to central clearing requirements and FICC's monitoring of transactions by its direct participants by June 14, 2024, and FICC's updated rules must be effective by December 31, 2025 for cash market transactions and June 30, 2026 for repurchase transactions.

Department of Labor (the "DOL") proposes fiduciary investment advice regulations. On November 3, the DOL proposed regulations to broaden the definition of "investment advice" under the Employee Retirement Income Security Act of 1974, which if adopted, would expand the circumstances in which a person would be considered a fiduciary. This is the DOL's fourth attempt since 2010 to expand fiduciary status. While this proposal differs from prior rulemakings that sought to broaden the scope of investment fiduciaries, the general aims are similar and an important question going forward will be whether the differences are sufficient enough for the rule to survive legal challenge. The proposed rule would also narrow the existing administrative exemptions from the prohibited transaction rules that govern fiduciaries. For additional information on the proposal, see our memo here.

SEC adopts final rule on short position and short activity reporting by institutional investment managers. On October 13, the SEC adopted Rule 13f-2, which requires certain institutional investment managers that exercise discretion over short positions in excess of the applicable reporting thresholds to file month-end reports on the new Form SHO detailing aggregate short positions and daily related activity. Although the reported information is confidential, the SEC will publish certain aggregated short sale data with a one-month delay, supplementing short sale information provided by U.S. stock exchanges and FINRA. The SEC also adopted an amendment to the CAT NMS Plan, requiring covered firms to report whether an order is a short sale effected by a bona fide market maker ("BFMM") in connection with BFMM activities for which the BFMM exception in Regulation SHO has been claimed. The compliance date for Rule 13f-2 and Form SHO reporting is January 2, 2025. The compliance date for the amendment to the NMS Plan is July 2, 2025. The National Association of Private Fund Managers, Managed Funds Association and the Alternative Investment Management Association have filed a lawsuit in the Fifth Circuit challenging the validity of both Rule 13f-2 and Rule 10c-1a (discussed below). The petitioners are represented by Sullivan & Cromwell LLP. For additional information about the final rule, see our memo here.

SEC adopts final rule mandating reporting on securities loans. On October 13, the SEC adopted Rule 10c-1a, which will require "covered persons" entering into or modifying covered securities loans to report the specific terms of each such loan by the end of the day on which the loan is entered into or modified to a registered national securities association, *i.e.*, FINRA. A covered person may rely on a broker, dealer or registered clearing agency to fulfill its reporting obligations. The rule requires reporting on 12 data points, including the amount of the loan, the type of collateral, and the name of the securities issuer. In addition, loans used to settle short sales will be reportable despite a number of comments to the proposal expressing concern that this requirement would reveal short positions. While FINRA will keep some of the disclosed terms confidential (including, for example, whether the covered securities loan is being used to close out a fail to deliver pursuant to Rule 204 of Regulation SHO or to close out a fail to deliver outside Regulation SHO), using them to monitor the lending market, FINRA is required to make the rest of the information public by the morning of the next business day. Loan amounts will be made public 20 business days following the submission of the report.

Covered persons or reporting agents will be required to begin providing this information on January 2, 2026. As mentioned above, the National Association of Private Fund Managers, Managed Funds Association and the Alternative Investment Management Association have filed a lawsuit in the Fifth Circuit challenging the validity of Rule 10c-1a. For additional information about the final rule, see our memo here.

SEC adopts final rule on beneficial ownership reporting. On October 10, the SEC adopted amendments to Regulation 13D-G and Regulation S-T to accelerate the filing deadlines for beneficial ownership reporting by market participants. Persons or groups that beneficially own more than 5% of a covered class of securities, other than exempt investors, passive investors and qualified institutional investors, will now have to publicly report their ownership on Schedule 13D no later than the fifth business day after acquiring a 5% holding (previously 10 calendar days) and Schedule 13D filers will have to make any material amendments within two business days (previously promptly after the material change occurs). Exempt investors and qualified institutional investors will generally have to file their reports on Schedule 13G within 45 days after the end of the quarter in which the investor acquired more than 5% of a covered class of securities (previously 45 days after the end of the calendar year). However, if the ownership threshold of qualified institutional investors exceeds 10% prior to the quarter-end, reporting must be made within five calendar days of the month-end when the threshold is crossed (previously 10 calendar days). Passive investors will need to file a Schedule 13G within 5 buisness days of reaching the 5% threshold, and then file an amendment upon a 5% increase or decrease in percentages. The SEC clarified that Schedule 13G filers will only have to file amendments for material changes to the facts previously reported, and accelerated in some cases the related filing deadlines for such amendments. The amendments also require the filings to be made using structured, machine-readable data language.

In a change from the proposed rules, the SEC did not adopt amendments to: (1) deem holders of cash-settled derivative securities to be beneficial owners of the underlying reference equity securities when the derivative securities are held with a control intent; (2) provide that a person becomes a member of a group if such person acquires securities after simply being notified that another person intends to file a Schedule 13D; (3) define when two or more persons "act as" a group; or (4) add safe harbors from group status for communications among institutional investors and ordinary course derivative transactions. The final rule went into effect on February 5, 2024 for Schedule 13D filers. The SEC delayed the effectiveness of the Schedule 13G filing deadline until September 30, 2024 and the structured data requirement until December 18, 2024. For additional information about the final rule, see our memo here.

California requires venture capital companies to report portfolio companies' demographic information. On October 8, California enacted the Fair Investment Practices by Investment Advisers law (SB 54), which will require venture capital firms to report to the California Civil Rights Department the demographic information of the founding members of companies in which they invest. The law is expected to have a wide impact, covering "venture capital companies," which is broadly defined and likely includes not only venture capital funds, but also private equity firms and family offices, among other asset managers, that have a nexus to California. Venture capital companies will be considered to have "nexus to California" if they (i) are headquartered in California, (ii) have a significant presence or operational offices in California, (iii) make investments in companies that are located or have significant operations in California, or (iv) solicit or receive investments from residents of California. Covered venture capital companies will be required to annually report aggregated demographic data collected via surveys sent to founding member teams. The initial reports must be filed by March 1, 2025 and cover investments made in the 2024 calendar year, although California Governor Newsom indicated in his signing statement that the reporting timeline is "unrealistic" and the law is expected to face legal challenges that could delay implementation.

SEC adopts amendments significantly expanding "Names Rule." On September 20, the SEC adopted amendments to Rule 35d-1 under the Investment Company Act. The amendments were largely in line with those proposed in June 2022 and significantly expand the application of Rule 35d-1, Notably, however, the SEC did not adopt the proposed prohibition of the use of ESG terminology in a fund name if such a fund met the proposed definition of an ESG "integration fund" (*i.e.*, a fund that considers one or more ESG factors alongside other, non-ESG factors in its investment decisions, but such ESG factors are generally no more significant than other factors in the investment selection process). Some of the significant elements of the amendments to the Names Rule include: (1) an expansion of the existing rule to any fund name that suggests an investment focus on “growth,” “value” or ESG strategies; (2) enhanced fund prospectus disclosure requirements for a fund subject to the 80% investment policy, such as defining terms used in its name and its investment criteria; (3) requirements to (i) determine whether an investment fits into the 80% investment policy at the time of its acquisition, and (ii) perform, at least quarterly, a review of the fund's portfolio assets' treatment under the 80% policy; (4) a 90-day window to bring a fund back into compliance with the 80% investment policy after any unintentional temporary departures; (5) requirements to value derivatives positions by notional amounts and short positions by price of the asset sold short; (6) prevention of unlisted closed-end funds and BDCs from changing their investment policies absent a shareholder vote; and (7) expansion of the reporting items required on Form N-PORT.

The final rule raises many interpretive issues as to whether a certain name conveys an investment strategy, focus or theme, and will impose substantial compliance costs, including from additional reporting obligations, on funds. Fund groups with net assets of $1 billion or more have 24 months to comply, and fund groups with net assets of less than $1 billion have 30 months to comply, in each case from December 10, 2023 (the final rule’s effective date). For additional information and analysis on the amendments, see our memo here.

Recent SEC Staff Guidance and No Action Letters

SEC updates responses to the FAQs for Form ADV and Form CRS. On October 26, the SEC Division of Investment Management updated its FAQs on Forms ADV and IARD, adding dozens of new questions addressing topics ranging from discussion of material changes in Item 2 of Form ADV to when to list an address for a social media account that features information about an adviser. On December 8, the Division of Investment Management and the Division of Trading and Markets updated their FAQs on Form CRS, covering a variety of topics, including filing requirements, delivery requirements, disciplinary history, recordkeeping and record making, and the investment adviser’s fiduciary duty.

SEC Staff responds to no-action request relating to Section 17(d)/Rule 17d-1 by Carlyle Global Credit Investment, Management, L.L.C. On October 19, the Staff confirmed to Carlyle Global Credit Investment Management, L.L.C. (“CGCIM”) its oral no-action position that it would not recommend enforcement action with respect to a series of transactions pursuant to which CGCIM became the investment adviser to Carlyle Credit Income Fund, Inc. (f/k/a Vertical Capital Income Fund, Inc. (the “Fund”)). Prior to the transaction, CGCIM did not own any shares of the Fund and was otherwise not an affiliated person of the Fund. Pursuant to the transaction agreement between the Fund and CGCIM, the parties carried out a multi-step transaction, including: a one-time payment from

CGCIM to Fund shareholders; a tender offer and the entry by the Fund and CGCIM into a series of voting agreements with certain Fund investors, the large majority of which owned 5% or more of the Fund's shares; and the purchase by CGCIM of newly issued shares in a primary issuance by the Fund.

The no-action letter noted "a series of actions that individually might not be prohibited under the Investment Company Act may be a 'joint enterprise or other joint arrangement or profit-sharing plan' within the meaning of Rule 17d-1, to the extent there is an element of combination between an investment company and its affiliated persons that links them together," citing *SEC* v. *Talley Industries, Inc*. In its request letter, CGCIM reasoned that the transaction did not implicate the self-dealing policy concerns underlying Section 17(d) prohibitions because (i) the terms of the transaction were fair and reasonable and (ii) the Fund's participation would be on terms equal to, and on a basis no less advantageous than, that of other participants. Specifically, CGCIM paid a large premium over the trading price of the shares, negotiated the terms of the transaction on an arm's-length basis following a competitive process, and entered into the transaction after the Fund's board of trustees, including all of the independent trustees, determined that the transaction was in the best interest of the Fund. Based on the specific facts and representations in CGCIM's letter, the Staff confirmed it would not recommend enforcement action under Section 17(d) of the Investment Company Act or Rule 17d-1 thereunder.

Disclosure Updates

SEC Staff publishes Dear CFO Letter addressing certain changes to accounting, reporting and disclosure matters. On November 29, the Staff of the Chief Accountant's Office of the Division of Investment Management published a letter providing clarity on several accounting, auditing, financial reporting and disclosure matters for registered investment companies, BDCs and registered investment advisers and their accountants. The updates include new Staff views on Form N-2 financial highlights for registered closed-end funds and BDCs, Regulation S-X Rule 6-11 requirements for RICs and BDCs to provide certain supplemental financial information in connection with fund acquisitions, and reminders about certain disclosure requirements related to new accounting standards, including noting that Item B.21 of Form N-CEN requires registrants to indicate any changes in accounting principles or practices that will materially affect a fund's financial statements. The Staff also withdrew prior Dear CFO Letters on adviser accounting for offering costs (1995-05) and audit guide implementation (2001-01) and modified prior Dear CFO Letters on pro forma fee and capitalization tables (1995-11), transmittal of reports and financial statements submitted via SEC EDGAR (1998-08), and auditor verification of securities owned for registered investment companies and BDCs (2019-01).

SEC proposes rule amending the offering process and creating disclosure requirements for registered index-linked annuities. On September 29, the SEC proposed rule and form amendments to create a specific form for offering registered index-linked annuities ("RILAs"). Specifically, the SEC would require

RILAs to register offerings on an amended Form N-4, which is currently used for variable annuity separate accounts. The amended Form N-4 would be specifically tailored to ensure that RILAs' key features are effectively communicated to purchasers. Additionally, the proposed rule would include certain amendments to Form N-4 based on investor testing that would apply to offerings of variable annuities and apply a current SEC rule providing guidance on when sales literature is materially misleading to RILA advertisements.

Recent Litigation and Enforcement Actions

SEC fines OEP Capital Advisors, L.P. ("OEP") $4,000,000 for failing to prevent the misuse of material, nonpublic information ("MNPI"). On December 26, the SEC announced it settled charges with OEP for allegedly failing to maintain and enforce written policies restricting the use of MNPI, as required by Sections 204A and 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, and engaging in misleading communications with current and prospective investors. According to the SEC order, between 2019 and 2022, OEP senior personnel sent investors, potential investors, and industry contacts emails that unnecessarily disclosed nonpublic information regarding M&A activity and other confidential OEP fund information, often in the context of marketing and fundraising. OEP agreed to pay a $4,000,000 penalty to resolve the matter.

SEC fines Eagan Capital Management, LLC ("Eagan Capital") $50,000 for violation of the custody rule. On December 1, the SEC issued an order instituting and settling administrative and cease and desist proceedings with Eagan Capital for violations of Rule 206(4)-2 under the Advisers Act (the custody rule), which requires, among other things, that investment advisers with custody of client assets produce audited financial statements or undergo, at least once each calendar year, a surprise examination by an independent public account with respect to such client assets. According to the SEC order, Eagan Capital provides investment advisory services to two private real estate operating companies ("REOCs") and invests in the REOCs on behalf of its advisory clients, the founder and the founder's family. The SEC alleged that Eagan Capital had custody of the REOCs' funds and securities after the REOCs issued loans to an Eagan Capital affiliate and the proceeds were used by such affiliate to invest in real estate on behalf of the REOCs. In addition, Eagan Capital held the paper membership interests in the REOCs on behalf of its clients. Between 2018 and 2021, Eagan Capital failed to undergo, at least once each calendar year, a surprise examination or produce audited financial statements for the REOCs. The SEC also alleged that Eagan Capital failed to have written policies in place to ensure compliance with the custody rule. Eagan Capital agreed to pay a $50,000 civil money penalty to resolve the matter.

Second Circuit affirms Southern District of New York ruling that control share bylaws violate the Investment Company Act. On November 30, the U.S. Court of Appeals for the Second Circuit upheld the district court's ruling that certain Nuveen closed-end funds violated Section 18(i) of the Investment Company Act by enacting bylaws that eliminated the voting rights of any shares purchased by an investor once such investor owned more than 10% of a fund's shares. Saba Capital CEF Opportunities 1, Ltd. and Saba Capital Management, L.P. (collectively, "Saba"), which owned at least 9.9% in each of the Nuveen funds, sued the Nuveen funds and trustees, seeking, among other things, that the new bylaws be rescinded. The Second Circuit affirmed the district court's February 2022 grant of motion of summary judgment for Saba, holding that (1) Saba had standing to sue, and (2) the voting restrictions in the bylaws violated the Investment Company Act's requirement under Section 18(i) that each common share of an investment company be voting stock that has equal voting rights with every other outstanding share of voting stock.

SEC and CFTC publish year-end enforcement updates. The SEC released its fiscal year 2023 enforcement results on November 14, while the CFTC released its results on November 7. The agencies continue to pursue enforcement actions against financial institutions, including investment advisers. The SEC brought actions against advisers allegedly involved in "cherry-picking" schemes, breaches of fiduciary duty, disclosure and compliance violations, AML and ESG program deficiencies, and violations related to fees, the custody rule and the marketing rule. SEC actions against broker-dealers included unauthorized trading, recordkeeping issues and inadequate information barriers, and misuse of MNPI. The CFTC brought a number of actions related to spoofing and other manipulative trading tactics, inadequate compliance and reporting programs, and the illegal use of confidential information.

SEC EXAMS

SEC Division of Examinations ("EXAMS") releases its 2024 examination priorities. On October 16, EXAMS released its 2024 examination priorities report. The report was published significantly earlier than in prior years. The 2024 report opens by noting that examining investment advisers will continue to be a priority this year, with a focus on advisers' adherence to their fiduciary duties in connection with their marketing practices, compensation arrangements, valuation of assets, safeguarding assessments, and full disclosures. In particular, EXAMS will continue its focus on examining investment advisers to private funds. In addition, EXAMS indicated a focus on compliance with newly promulgated rules and investment advice and recommendations with regard to complex, illiquid and unconventional products offered by investment advisers and investment companies, such as derivatives, ETFs and REITs, and private placements. EXAMS' key emerging risk areas include information security and operational resiliency, crypto assets and emerging financial technology, regulation systems, compliance, and integrity (SCI) and anti-money laundering. Notably, the examination priorities do not explicitly refer to ESG investing this year, representing a departure from the examination priorities reports for the past three years.

SEC publishes a risk alert for investment advisers regarding assessing risks, scoping examination and requesting documents. On September 6, EXAMS published a risk alert outlining its approach with respect to selecting investment advisers for examination and determining the risk areas to examine. EXAMS indicated that the following factors play a role in which advisers are selected: the firm's risk characteristics; any tips, complaints, or referrals; and the Staff's interest in a particular compliance risk area. Once selected, however, the actual scope of the examination varies, driven by the firm's business model, associated risks, and the reason for conducting the examination. EXAMS provided the risk alert to prepare advisers for the process upon receiving a letter of examination, listing the following types of information initially requested from advisers: general information (including organizational, business and operations, disclosures and filings, and legal and disciplinary information); information about compliance risks identified by the adviser and the written policies and procedures adopted and implemented to address those risks; information to facilitate testing with respect to advisory trading activities; and information relating to testing for compliance in various areas.

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