OFFERING REFORMS OR BURDENSOME REGULATIONS? IT DEPENDS!

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Investment Management Alert

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On March 20, 2019, the Securities and Exchange Commission ("SEC") proposed several rules (the "Proposed Rules") that would modify the registration, communications, and offering processes for closed-end management investment companies ("Registered CEFs") and business development companies ("BDCs," and, together with Registered CEFs, the "Affected Funds") under the Securities Act of 1933, as amended ("Securities Act").[1] The Proposed Rules implement provisions of the Economic Growth, Regulatory Relief, and Consumer Protection Act (the "CEF Act") and Small Business Credit Availability Act (the "BDC Act"), and would generally provide the Affected Funds with flexibility to follow more lenient securities offering rules currently available to traditional public operating companies.

Whether the Proposed Rules represent an opportunity for a streamlined offering and communication process or just more regulatory burden with little benefit depends on the type of Affected Fund. The Proposed Rules may be a welcome development for traditional exchange listed Registered CEFs and BDCs that seek to raise capital, finally extending many of the offering reforms that operating companies have enjoyed for over a decade. However, for other types of Registered CEFs, including continuously offered closed-end funds (both interval funds and tender offer funds), the Proposed Rules impose new regulatory burdens with little, if any, benefit.

This alert provides an overview of the Proposed Rules and an analysis of their implications for the Affected Funds. As noted above, overall, the Proposed Rules provide a more efficient and cost-effective approach for the Affected Funds to raise capital and engage in the registration process; however, many proposals may increase the regulatory burden on Affected Funds, particularly Registered CEFs, especially those not currently seeking to raise capital. For example, Registered CEFs would be required to file information on Form 8-K as well as include management's discussion of fund performance ("MDFP") in annual shareholder reports, which had historically been optional.

I. Background and Scope of Proposed Rules

The SEC adopted securities offering reforms for operating companies in 2005 for purposes of modernizing the securities offering process. However, at the time, investment companies, including the Affected Funds, were excluded from the scope of the reforms. When Congress passed the CEF Act in May 2018, it directed the SEC to allow any closed-end fund listed on a national securities exchange or that makes periodic repurchase offers under Rule 23c-3 under the Investment Company Act of 1940, as amended (the "1940 Act"), to utilize these securities offering rules available to operating companies.[2] The Proposed Rules extend beyond the CEF Act and make the new reforms available to *all* Registered CEFs, including Registered CEFs not listed on any stock exchange ("unlisted Registered CEFs"). Similar to the CEF Act, the BDC Act, which was signed into law in March 2018 and scheduled to go into effect on March 23, 2019, directed the SEC to afford the same flexibility to listed and unlisted

BDCs. Although certain benefits of the rules that the SEC is proposing to amend, under their existing terms, are less likely to apply to unlisted issuers, the scope of the Proposed Rules would generally treat unlisted Registered CEFs, BDCs, and operating companies in a consistent manner.

The Proposed Rules do not apply uniformly to all Affected Funds; rather, certain categories of Affected Funds would have different treatment under different proposals. As described below, several of the Proposed Rules would apply only to "seasoned funds," which are Affected Funds that are current and timely in their reporting and therefore generally eligible to file a short-form registration statement if they have at least $75 million in "public float."[3] Other Proposed Rules apply only to seasoned funds that also qualify as "well-known seasoned issuers" ("WKSIs"), which are seasoned funds that generally have at least $700 million in public float. In the proposing release, SEC staff noted that it has considered that unlisted funds, including interval funds, would generally not have a public float. The staff has requested comments regarding extending the benefits of the WKSI reforms to Affected Funds that would not qualify because they do not have the requisite public float. The chart in Appendix I summarizes the implication of each Proposed Rule for the entities affected by the changes.

II. Executive Summary of Proposed Rules

Streamlined Shelf Offering Process

- Seasoned funds would have a faster and more efficient shelf registration process through the use of a new short-form registration statement. Seasoned funds would also have the ability to forward and backward incorporate by reference information from their Securities Exchange Act of 1934, as amended ("Exchange Act"), reports.

WKSI Status

- Eligible funds would be able to qualify as WKSIs (like operating companies) and benefit from a more flexible registration process, which would include the ability to file automatically effective registration statements and amendments.

Prospectus Delivery and Communications Reforms

- Affected Funds could satisfy their final prospectus delivery obligations by filing their final prospectuses with the SEC.
- Affected Funds could use many of the offering communication rules currently available to operating companies, enabling such funds to use a "free writing prospectus," certain factual business information, forward-looking statements, and certain broker-dealer research reports.

New Method for Interval Funds to Pay Registration Fees

- Interval funds could register an indefinite number of shares and pay registration fees based on net issuance of shares by filing on Form 24F-2, similar to the method that open-end funds use.

Structured Data Requirements

- Certain Affected Funds would be required to use Inline eXtensible Business Reporting Language ("Inline XBRL") format to tag certain registration statement information, similar to current tagging requirements for open-end funds.

- Funds that file Form 24F-2 in connection with paying their registration fees would be required to submit the form in Extensible Markup Language ("XML").

Annual Report Requirements

- Seasoned funds that register using the short-form "shelf" registration statement would be required to disclose material unresolved staff comments and include certain key information in their annual reports.
- Registered CEFs would have to include MDFP in their annual reports, similar to requirements that currently apply to mutual funds, exchange-traded funds, and BDCs.

Reporting on Form 8-K

- Registered CEFs would be required to file current reports on Form 8-K. Form 8-K would also be amended to require information regarding material changes to investment objectives and material write-downs of significant investments.

Incorporation by Reference Changes

- While Affected Funds must currently provide new purchasers with a copy of all previously filed materials that are incorporated by reference into the registration statement, the Proposed Rules would eliminate this requirement and instead require such funds to make incorporated materials readily available on a website.

III. Discussion of Proposed Rules

The key changes addressed by the Proposed Rules are highlighted below.

Streamlined Shelf Offering Process

Affected Funds would be permitted to sell securities "off the shelf" faster and more efficiently due to a number of proposed reforms.[4] Currently, issuers that are permitted to register their securities offerings on Form S-3 may conduct shelf offerings under Rule 415(a)(1)(x) under the Securities Act.[5] However, the rules with respect to operating companies making shelf offerings have historically been more flexible than for the Affected Funds. For example, Affected Funds have limited ability to incorporate information by reference into their registration statements and are unable to forward incorporate information from subsequently filed Exchange Act reports. Form N-2 allows registrants to *backward* incorporate financial information from a previously filed report, but only under limited circumstances. Affected Funds also cannot rely on Rule 430B under the Securities Act, which permits certain issuers to omit information from a base prospectus. Further, Affected Funds cannot file automatic shelf registration statements, as only WKSIs are allowed to file such statements.

The Proposed Rules would permit entities affected by the changes to:

- File short-form registration statements on Form N-2, which would function like a Form S-3 registration statement. An entity could then use the registration statement to register shelf offerings, including shelf registration statements filed by WKSIs that become effective automatically.
- Fulfill Form N-2's disclosure requirements by incorporating by reference information from the fund's Exchange Act reports (which are filed under 1940 Act provisions).
- Rely on Rule 430B under the Securities Act to omit information from their base prospectuses.

- Utilize the process operating companies follow to file prospectus supplements. Specifically, the SEC proposes to amend Rule 497 under the Securities Act to provide that Rule 424 would be the exclusive rule for Affected Funds to file a prospectus supplement other than an advertisement that is deemed to be a prospectus under Rule 482 under the Securities Act.
- Include additional information in periodic reports to update their registration statements.

Overall, these changes provide exchange-listed Affected Funds with greater flexibility to control the timing of their capital raising, particularly given that Section 23(b) of the 1940 Act generally prohibits a Registered CEF (and BDC) from issuing shares at a price below the fund's current net asset value without shareholder approval. As the shares of Affected Funds often trade at a discount to net asset value, the ability to quickly access the markets when shares are trading at a premium, particularly through selling securities off the shelf, is valuable.

WKSI Status

Affected Funds would no longer be excluded from qualifying as WKSIs, if, as discussed above, a fund is a seasoned fund and has $700 million in public float. WKSIs were created as a new category of issuer in 2005 and benefit to the greatest degree from the rule changes afforded to operating companies at that time. Specifically, WKSIs have more flexibility to (i) file automatically effective registration statements and amendments; and (ii) communicate at any time, including through means of a free writing prospectus, without violating certain "gun-jumping" provisions (as discussed below) of the Securities Act. As a result of the Proposed Rules, Affected Funds may qualify as WKSIs if they meet the requisite requirements.

The Proposed Rule would also make the following changes with respect to WKSI status:

- While the current WKSI definition provides that an issuer must meet the registrant requirements of Form S-3, there would be a parallel reference to the registrant requirements of the proposed short-form registration instruction.
- The definition of "ineligible issuer" in Rule 405 under the Securities Act would be amended to provide that a Registered CEF would be ineligible if it has failed to file all reports and materials required to be filed under Section 30 of the 1940 Act during the preceding 12 months, consistent with the proposed short-form registration instruction and Exchange Act reporting provision in the ineligible issuer definition. The definition of ineligible issuer would also give effect to the current anti-fraud prong in that definition in the context for Affected Funds.

Prospectus Delivery and Communications Reforms

A. Prospectus Delivery Reforms

Affected Funds would be allowed to satisfy their final prospectus delivery obligations by filing their final prospectuses with the SEC. Section 5(b)(2) of the Securities Act makes it unlawful to deliver a security for the purpose of sale or for delivery after sale unless accompanied or preceded by a final prospectus.[6] Rule 172 of the Securities Act provides a carve-out so that issuers may satisfy final prospectus delivery obligations if a final prospectus is or will be on file with the SEC within the time required by the rules and if other conditions are satisfied. Affected Funds are currently excluded from the provisions of Rule 172, but the Proposed Rules would remove that exclusion.

B. Communications Reforms

The communications reforms provided by the Proposed Rules allow for Affected Funds to abide by the same offering communications rules available to operating companies. Currently, the Affected Funds are subject to restrictions on the types of communications that can be used in connection with a registered public offering, colloquially referred to by the staff as "gun-jumping" provisions. These restrictions include: (i) the prohibition of any offer before an issuer files a registration statement; (ii) the prohibition of any written offer before a registration statement has become effective unless the offer is made using a preliminary prospectus; and (iii) the limitation that written offers may only be made through statutory prospectuses after a registration statement is declared effective, subject to certain exceptions. The Proposed Rules would modify these restrictions by:

- Allowing Affected Funds to use certain communications to publish factual information about the issuer or the offering (including tombstone ads).
- Affording Affected Funds a bright-line time period, ending 30 days prior to the filing of a registration statement, during which they may communicate without risk of violating the "gun-jumping" provisions mentioned above.
- Permitting Affected Funds that are reporting companies to disseminate regularly released factual business and forward-looking information at any time.
- Permitting Affected Funds to rely on Rules 164 and 433 under the Securities Act to use a "free writing prospectus."
- Allowing Affected Funds that are also WKSIs to engage at any time in oral and written communications, including use at any time of a free writing prospectus (before or after a registration statement is filed), subject to the same conditions applicable to other WKSIs.
- Permitting changes to Rule 138 of the Securities Act, which allows broker-dealers participating in a distribution of an issuer's common stock to publish or distribute research about that issuer's fixed income securities if it publishes or distributes that research in the regular course of its business, to clarify that Affected Funds may rely on the rule.

These changes are in addition to Proposed Rule 163B under the Securities Act, released by the SEC on February 19, 2019. Proposed Rule 163B would enable all issuers, including investment companies registered under the 1940 Act, to engage in "test-the-waters" communications with certain institutional investors regarding a contemplated registered securities offering prior to, or following, the filing of a related registration statement. These communications would be exempt from restrictions imposed by Section 5 of the Securities Act on written and oral offers prior to or after filing a registration statement and would be limited to communications with qualified institutional buyers and institutional accredited investors. More information about this proposal can be found in the K&L Gates client alert 'SEC Proposes New Rule to Expand "Test-the-Waters' Modernization Reform to Registered Investment Companies," available here.

New Method for Interval Funds to Pay Registration Fees

Registered CEFs that operate as "interval funds" would be able to register an indefinite number of shares and pay registration fees based on net issuance of shares, similar to the method that mutual funds and exchange-traded

funds use. Registered CEFs are currently required to pay registration fees at the time they register securities, irrespective of when they sell them. In contrast, the 1940 Act allows many registered investment companies, such as mutual funds and exchange-traded funds, to register an indefinite amount of securities upon their registration statements' effectiveness and pay registration fees based on their net issuance of shares by filing on Form 24F-2 no later than 90 days after the fund's fiscal year end. The Proposed Rules would require interval funds to pay registration fees by filing on Form 24F-2. Interval funds would benefit from the ability to pay registration fees in this manner because the approach would avoid the possibility that an interval fund would inadvertently sell more shares than it had registered and would not require interval funds to periodically register new shares.

Structured Data Requirements

The Proposed Rules create several new structured data reporting requirements for Affected Funds. First, the rules would require BDCs to submit financial statement information using Inline XBRL format in the same way as operating companies. The SEC requires mutual funds and exchange-traded funds (as well as operating companies) to submit certain information, such as prospectus risk/return summary information, using Inline XBRL format. BDCs are currently subject to neither the structured data reporting requirements for operating companies nor those for registered investment companies. The Proposed Rules would subject BDCs to Inline XBRL financial statement tagging requirements that apply to operating companies.

Second, the Proposed Rules would require Affected Funds to include structured cover page information in their registration statements on Form N-2 using Inline XBRL format and include certain information in their prospectuses using Inline XBRL format. Specifically, the Proposed Rules would require Affected Funds to tag data points on the cover page of Form N-2. The SEC currently requires registrants to tag all data points on the cover page of Form 10-K, Form 10-Q and Form 8-K, among others, and believes that extending this requirement to Form N-2 would allow investors to automate their use of the information. In addition, the Proposed Rules would require Affected Funds to tag disclosure regarding the Fee Table, Senior Securities Table, Investment Objectives and Policies, Risk Factors, Share Price Data, and Capital Stock, Long-Term Debt, and Other Securities in their prospectuses. The SEC staff believes that these key items of disclosure would be of greatest utility for investors that seek to compare funds. However, CEFs vary tremendously, frequently with unique strategies, and often present very different characteristics and disclosures, making them less comparable than the more numerous open-end funds in existence. Therefore, it is questionable that tagging CEF disclosure would produce a benefit sufficient to justify the burdens the tagging would impose on Affected Funds.

The Proposed Rules would also require filings on Form 24F-2 to be submitted in XML format. The SEC staff noted that while this would be an additional requirement for Affected Funds, the process could help such issuers compute registration fees before submitting the filing and facilitate the pre-population of previously filed information.

Annual Report Requirements

In order to facilitate the proposed short-form registration statement framework, annual reports would be elevated in importance relative to prospectus disclosure for Affected Funds. Accordingly, the SEC proposed to require seasoned funds that register using the short-form registration instruction to include key information in their annual reports with respect to fees and expenses, share price data (including data regarding premiums and discounts), and outstanding senior securities.

In addition, Registered CEFs would be required to include an MDFP in their annual reports. The SEC requires mutual funds and exchange-traded funds to include MDFP disclosure, and BDCs to include management discussion and analysis ("MD&A") disclosure, in their annual reports. However, Form N-2 does not currently include an MDFP or MD&A requirement for Registered CEFs. The Proposed Rules would require, similar to Form N-1A, that Registered CEFs: (i) discuss factors that materially affected performance over the past year; (ii) provide a line graph comparing initial and subsequent account values at the end of each of the most recently completed 10 fiscal years; (iii) include a table showing the fund's total returns for the one-, five-, and 10-year periods as of the last day of the fund's most recent fiscal year; and (iv) discuss the effect of any policy or practice of maintaining a specified level of distributions to shareholders on the fund's investment strategies and net asset value during the past year, and the extent to which the distribution policy resulted in distributions of capital. These new requirements not only impose a new burden in the annual reporting process but will require Registered CEFs listed on the New York Stock Exchange to have their audit committee review the MDFP as part of its review of the annual report.[7]

The Proposed Rules would also require BDCs to provide financial highlights in their registration statements and annual reports, similar to the current requirements for Registered CEFs. As it is already general market practice for BDCs to include such information in registration statements and annual reports, we do not expect this obligation to be burdensome.

Finally, the Proposed Rules would require Affected Funds filing a short-form registration statement on Form N-2 to disclose material unresolved staff comments in the registration statement and in annual reports. The SEC staff reasoned that because funds filing short-form registration statements on Form N-2 would generally no longer need to file annual post-effective amendments subject to staff review, the disclosure requirement would provide an incentive for Affected Funds to timely resolve staff comments. This appears to be a back-door regulatory approach with little precedence.

Reporting on Form 8-K

The Proposed Rules would require Registered CEFs to report information on Form 8-K. Registered CEFs are generally not required to file a Form 8-K, although some do so voluntarily, including in connection with certain exchange rules.[8] In contrast, BDCs are mandated to file reports on Form 8-K to provide information about significant events. In order to address the lack of parity between Registered CEFs and BDCs in terms of current reporting to investors and the market, the SEC not only proposed to require Registered CEFs to report certain information on Form 8-K, but also proposed to amend Form 8-K to (i) add two new reporting items for Affected Funds on material changes to investment objectives or policies and material write-downs of significant investments; and (ii) tailor existing reporting requirements and instructions to Affected Funds. The requirement to file a Form 8-K is a significant new regulatory burden for Registered CEFs, especially since Form 8-K would require disclosure within four business days of a relevant event, while the existing regime under Rule 8b-16 under the 1940 Act calls for disclosure on an annual or semi-annual basis. Notably, unlisted continuously offered CEFs, which gain almost none of the benefits of the Proposed Rules, would receive a new regulatory burden, despite offering on a current prospectus at all times.

Incorporation by Reference Changes

In addition to the proposal to permit expanded incorporation by reference for Affected Funds that file a short-form registration statement on Form N-2, the Proposed Rules would allow Affected Funds to make materials

incorporated by reference accessible on a website, rather than delivered to investors. Form N-2 requires that a fund provide to new investors a copy of all previously filed materials that the fund incorporated by reference into the prospectus and/or SAI in response to certain items of the form. This requirement is more onerous for BDCs, which typically do not take advantage of the backward incorporation by reference currently permitted by Form N-2 because they are required to include financial statements in the prospectus. Operationally, this means that each time a BDC delivers a prospectus to an investor, it must determine whether that investor is a new investor and then deliver any incorporated material. Registered CEFs, on the other hand, are only minimally affected by the obligation to deliver incorporated materials to new investors because they are required to include financial statements in the SAI, which is delivered only upon request. The Proposed Rules, which would allow Affected Funds to make materials incorporated by reference accessible on a website alongside the corresponding prospectus and statement of additional information, would therefore relieve BDCs of the operational challenges currently associated with delivering materials incorporated by reference to investors. However, both Registered CEFs and BDCs should consider that the proposal also subjects them to liability with respect to information that has not previously been incorporated into their registration statements.

IV. Conclusion

The SEC requested comment regarding several aspects of the proposed reforms discussed above. We believe industry participants should respond and consider in particular commenting on the following questions posed by the SEC:

- Rather than amending Form N-2, should the SEC create a separate registration form specifically for Affected Funds to file a short-form registration statement?
- Should the SEC adopt a different level of public float for an Affected Fund to qualify as a WKSI (or to file a short-form registration statement on Form N-2), or a different metric in lieu of an Affected Fund's public float? Should the SEC, for example, provide for a different metric for interval funds, whose shares are generally not listed on an exchange, or for other unlisted Affected Funds?
- Should the SEC amend its rules to deem an interval fund to have registered an indefinite amount of securities upon effectiveness of its registration statement, as proposed? Should the SEC require interval funds to pay registration fees on an annual net basis by filing on Form 24F-2?
- Should the SEC require MDFP information to appear in a Registered CEF's annual report? If so, should they further tailor the current MDFP requirements applicable to mutual funds and exchange-traded funds for Registered CEFs?
- Should the SEC require disclosure of unresolved staff comments? Are there more appropriate means to provide incentives to timely resolve staff comments?
- Should all Registered CEFs be required to disclose current information on Form 8-K? If not, why should certain or all Registered CEFs be permitted to make use of the registration, communications, and offering amendments discussed in this proposal without providing current information to the market, unlike operating companies and BDCs?
- Would increased liability with respect to information that has not previously been incorporated into a fund's registration statement raise any concerns unique to Affected Funds? For example, is there any

information in Registered CEFs' annual and semi-annual reports that should not be incorporated by reference? If so, which information and why?

The Proposed Rules will have a 60 day public comment period following their publication in the Federal Register. If the SEC does not finalize a form of the Proposed Rules within two years of enactment of the CEF Act, listed Registered CEFs and CEFs that make periodic repurchase offers under Rule 23c-3 would be deemed to be eligible issuers under the 2005 securities offering reform rules.[9] In addition, pursuant to the BDC Act, BDCs are permitted to treat the revisions required by the Act as having been made in accordance with the specifications set out for the SEC within the Act until final rules are adopted.[10] As such, BDCs can currently rely on the reporting and communications reforms provided by the BDC Act, but should be wary of acting contrary to the SEC's Proposed Rules.

CEF sponsors, and particularly sponsors of unlisted continuously offered CEFs, should consider the Proposed Rules with great care, and consider commenting in light of the burdens imposed. If you have any questions regarding these matters, please contact any of the authors listed above or one of the K&L Gates attorneys with whom you work.

Notes:

To view the appendix, please click here.

[1] Securities Offering Reform for Closed-End Investment Companies, SEC Release Nos. 33-10619, 34-85382 and IC-33427 (Mar. 20, 2019) (the “Proposing Release”).

[2] The CEF Act required the SEC to propose rules relating to this direction within one year of the Act's enactment.

[3] The term “public float” generally refers to the definition of an issuer's “aggregate market value” in Form S-3. Form S-3 defines “aggregate market value” as the “aggregate market value of the voting and non-voting common equity held by non-affiliates.” The SEC has stated that this determination is based on a public trading market, such as an exchange or certain over-the-counter markets.

[4] We note that interval funds and similar tender offer funds would not be able to file short-form registration statements. Such funds make continuous offerings, and interval funds have their own offering provision (Securities Act Rule 415(a)(1)(xi)), and certain post-effective amendments to their registration statements are immediately effective under Rule 486(b) under the Securities Act. Therefore, interval funds currently have a tailored registration process that provides some of the same efficiencies as the short-form registration statement.

[5] In a shelf offering, a seasoned issuer may register an unallocated dollar amount of securities for sale at a later time, allowing such issuers to take advantage of favorable market conditions.

[6] A final prospectus is a prospectus that meets the requirements of Section 10(a) of the Securities Act.

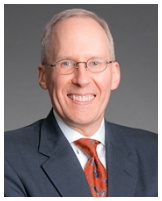
[7] *See* New York Stock Exchange (“NYSE”) Listed Company Manual Rule 303A.07(b)(iii)(B), which states that the audit committee must “meet to review and discuss the listed company's annual audited financial statements and quarterly financial statements with management and the independent auditor, including reviewing the listed company's specific disclosures under “Management's Discussion and Analysis of Financial Condition and Results of Operations.””

[8] For example, NYSE Listed Company Manual Sections 202.05 and 202.06 and Nasdaq Rule 5250(b)(1) require the reporting of certain types of information to the public, which some funds may choose to do by filing a Form 8-K.

[9] *See* Final Rule, "Securities Offering Reform" (70 Fed. Reg. 44722; published August 3, 2005).

[10] The BDC Act provided that if the SEC failed to complete the revisions required by the Act within one year of the Act's enactment, BDCs could, until the SEC completed the revisions, deem the revisions to have been completed in accordance with the actions required to be taken by the SEC under the Act.

KEY CONTACTS



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