Public Statement

Statement on the Adoption of Changes to the Offering Rules for Closed-End Funds and Business Development Companies

Commissioner Allison Herren Lee

April 8, 2020

I want to start by recognizing the hard work of the staff in the Division of Investment Management, the Division of Corporation Finance, and the Division of Economic and Risk Analysis. The current circumstances present new and significant challenges to the staff every day, and you have continually done all that is asked of you and more. It would be an understatement to say that the Commission has been busy these past few weeks, and your diligence, professionalism, and commitment to the agency's mission is an inspiration.

Today's rules extend to business development companies (BDCs) and closed-end funds the securities offering and communication provisions that the Commission granted to operating companies in its 2005 Securities Offering Reform rules.[1] Those rules made significant changes to the offering and communications provisions applicable to operating companies, especially with respect to a category of the largest and most widely-followed public companies—known as "well-known seasoned issuers" or "WKSIs."[2] The 2005 changes gave WKSIs and other operating companies increased flexibility and reduced the level of staff review over their disclosures.[3] We now extend those changes to non-operating companies.

Certain aspects of today's final rules, in particular those applicable to BDCs, were specifically mandated by self-executing legislation that became effective a year ago. The Commission's action today with respect to BDCs largely formalizes those changes.[4] However, much of what is in these final rules is not dictated by legislation, but left to the Commission's discretion. That discretion has been exercised to drop important features from the proposal that were specifically designed to ensure that BDC and closed-end fund investors, most of whom are retail investors, received timely access to material information, and to make additional changes that reduce staff and Commission oversight of material changes to existing funds, including certain funds not even covered by the legislation.

Unfortunately, I am unable to support these rules both because of their timing and their substance.

TIMING

As I noted in a statement last week, the current market volatility and on-going national emergency require that the Commission proceed cautiously before undertaking action outside of what is specifically called for by the market effects of the immediate public health crisis.[5] In weighing the relevant considerations set forth in that statement, I cannot agree that we should undertake this rulemaking at this time.

These rules stem from a proposal published over a year ago, and do not address conditions stemming from the COVID-19 crisis. Moreover, we choose this moment to weaken protections for retail investors. Both BDCs and closed-end funds are largely owned by retail investors—those who have been hit hard by the recent market turmoil and who are least able to recover. In fact, the changes adopted today actually drop material disclosure requirements that were included in the proposal a year ago, and roll back important investor protection features. We are reducing protections in the midst of a crisis that has caused staggering losses for fund investors, with no clear idea when such losses may abate. As with other recent rulemakings, we roll back investor protections, asserting, without evidence, that we believe we are nevertheless maintaining sufficient protection.[6] This is not the time to engage in such speculation.

SUBSTANCE

Turning to the substance of the rules, the changes adopted today fall short in two significant investor protection areas. First, the final rules fail to include the proposed Form 8-K reporting requirements, similar to those for operating companies, despite the purported rationale of creating parity between funds and operating companies. And second, by allowing certain funds to make material changes automatically effective, the rules remove an important tool from the staff to ensure that fund sponsors adequately address our concerns. Had the the final rules come out differently on these two items, and had we at least waited past the peak of this public health crisis, I likely would have supported the rules.

Dropping the 8-K Requirement

For closed-end funds, the legislation specifically empowered the Commission to set appropriate conditions on the use of the 2005 offering and communications rules, leaving significant discretion to the Commission in crafting the rule.[7] The 2005 rules relied heavily on the fact that large issuers—especially WKSIs—are typically subject to scrutiny by a significant number of analysts and institutional investors, and that such scrutiny operated as a check on their disclosure.[8] BDCs and closed end funds, however, have limited analyst coverage and are largely held by retail, not institutional, investors.[9] Nevertheless, the final rules purport to rest on the rationale that parity with operating companies is justified. That parity, however, is notably not applied to require funds to provide retail investors with more timely access to material information on Form 8-K.

Last year's proposal would have required closed-end funds to file current reports with the Commission on Form 8-K, as is already required of operating companies and BDCs.[10] Additionally, it proposed to add two new items to Form 8-K for both BDCs and closed-end funds that would have required a current report in the event of a material change in a fund's investment strategy or policies,[11] or upon a material write-down of a significant investment of the fund.[12] These new items, which do not apply in the operating company context, were proposed specifically to add material information relevant to fund investors.[13] The proposal explained at the time that current reports were a significant component of the 2005 securities offering rules and specifically highlighted the need for mandatory—rather than voluntary—reporting to ensure timely and uniform disclosure practices across closed-end funds and BDCs.[14]

It is a fairly straightforward proposition that investors need timely information about material events, such as a material write-down of a significant investment, and the market volatility brought on by the current public health crisis brings this logic into sharp focus. Additionally, a fund may well determine to adapt to the present challenges by making changes to its investment strategies. More than ever, investors need timely information about the ways in which that fund is deploying or redeploying capital. Instead, today's final rules fail to require that investors receive that information on a timely basis and rely too heavily on inconsistent existing disclosure practices.

Undermining Commission and Staff Oversight

In addition, today's changes will allow certain continuously-offered closed-end funds and BDCs that do not qualify as WKSIs to make material changes to their registration statement without requiring those changes to be declared effective by the staff.[15] Such changes could include, among other things, material changes in investment

strategy or the types of assets in which the fund will invest. This is a sea change that goes further than the proposal and degrades a significant and effective investor protection tool used by the staff. Last year's proposal would have allowed continuously-offered closed-end funds and BDCs to make certain routine updates to their registration statements that would become effective automatically.[16] The final rules, however, significantly expand that proposed change and go well beyond the requirements of the legislation.

Most importantly, this change undermines our ability to ensure that continuously-offered closed-end funds and BDCs reasonably respond to staff comments and concerns prior to making material changes effective.[17] Staff has confronted a number of novel and complex issues in the closed-end fund space over the past several years. In many instances, the requirement that the staff declare an amendment effective has proven critical in helping to resolve those issues and adequately addressing staff and Commission concerns. This change eliminates an important and commonly used tool and erodes the ability of the staff and the Commission to address any investor protection issues before a material change becomes effective.[18]

We are an agency with a mission to protect investors. During this public health crisis, we have taken a number of important and necessary steps designed to ensure the effective operation of the capital markets that have resulted in a reduction, albeit temporarily, in the information available to investors. While I have supported most of these efforts, we must consider our actions today and the reduction in investor disclosure and protections in this context. I cannot support what I consider to be a particularly ill-timed additional rollback of protections for retail investors, and I respectfully dissent.

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[1] *See* Final Rule: Securities Offering Reform for Closed-End Investment Companies, Securities Act Rel. No. [FORTHCOMING] (Apr. 8, 2020) ("BDC-CEF Offering Reform Adopting Release"). See also Final Rule: Securities Offering Reform, Securities Act Rel. No. 8591 (July 19, 2005) ("2005 Securities Offering Reform Adopting Release").

[2] *See* 2005 Securities Offering Reform Adopting Release, *supra* note 1.

[3] *Id.*

[4] *See* Section 803(b) of Small Business Credit Availability Act, Pub. L. No. 115–141, 132 Stat. 348 (2018). The legislation required the Commission to adopt rules—the details of which were largely spelled out in the legislative text—by March 23, 2019. *Id*. The legislation also provided that, if the Commission did not adopt rules by the required deadline, BDCs would nonetheless be able to act as though such rules had been adopted. *See* Section 803(d).

[5] *See* Regulatory Priorities and COVID-19, Statement of Commissioner Allison Herren Lee (Apr. 3, 2020), https://www.sec.gov/news/public-statement/statement-lee-regulatory-priorities-covid-19-2020-04-03.

[6] Despite significant changes to disclosure requirements, staff review of registration statements and amendments, and the ability of material changes to become effective automatically, the Adopting Release omits discussion of the ways in which such changes might undermine investor protection and provides little discussion of how the remaining requirements remain sufficient to fill that gap. For instance, the Adopting Release specifically states that extending Rule 486 to non-WKSI, continuously-offered closed-end funds will provide such funds many of the same benefits afforded to WKSIs, but fails to address the ways in which the lesser public scrutiny of such funds and the lack of liquidity for investors might present additional investor protection concerns if material changes are made effective without the need for staff or Commission action. *See* BDC-CEF Offering Reform Adopting Release, *supra* note 1, at 52-59. Instead, the Adopting Release simply states that the Commission could address certain investor protection concerns by issuing a stop order, but provides no discussion of the relative difficulty of such a process and the burden that it would place on Commission resources. Likewise, the changes permit closed-end funds—even non-traded closed-end funds that are not covered by the legislation—to use "access equals delivery" to avoid the need to provide investors with a copy of the fund's prospectus. *See id.* at 59-

61. The Commission used its discretion to make that change without any substantive discussion of the investor base of most closed-end funds or whether the relevant investors are more or less likely to be able to access a fund's prospectus online. In fact, research suggests that approximately 37% of households invested in closed-end funds are retired individuals—compared with only 23% of households in mutual funds. *See* ICI, Investment Company Fact Book 2019: A Review of Trends and Activities in the Investment Company Industry at 111 (2019), https://www.ici.org/pdf/2019_factbook.pdf. Requiring retail investors, and especially retired retail investors, to search for a fund's prospectus on the internet raises significant investor protection concerns that warrant a more thoughtful examination by the Commission.

[7] *See* Section 509(a) of Economic Growth, Regulatory Relief, and Consumer Protection Act, Pub. L. No. 115–174, 132 Stat. 1296 (2018) (directing the Commission to, within two years "finalize any rules, *as appropriate*,

to allow any closed-end company . . . listed on a national securities exchange or that makes periodic repurchase offers . . . to use the securities offering and proxy rules, *subject to conditions the Commission determines appropriate*, that are available to other issuers that are required to file reports under section 13 or section 15(d) of the Securities Exchange Act of 1934. Any action that the Commission takes pursuant to this subsection shall consider the availability of information to investors, including what disclosures constitute adequate information to be designated as a 'well-known seasoned issuer'" (internal citations omitted) (emphasis added)).

[8] *See* 2005 Securities Offering Reform Adopting Release, *supra* note 1, at 23 ("Today, the largest issuers are followed by sophisticated institutional and retail investors, members of the financial press, and numerous sell-side and buy-side analysts that actively seek new information on a continual basis . . . The communications of these well-known seasoned issuers are subject to scrutiny by investors, the financial press, analysts, and others who evaluate disclosure when it is made.').

[9] See Proposed Rule: Securities Offering Reform for Closed-End Investment Companies, Securities Act Rel. No. 10619 at 42 (Mar. 20, 2019) ("BDC-CEF Offering Reform Proposing Release") ("Affected funds . . . have limited analyst coverage relative to operating companies and many have high levels of retail, rather than institutional, investors." *See also* BDC-CEF Offering Reform Adopting Release, *supra* note 1, at 136 ("Studies have shown, however, that the majority of investors in operating companies are institutional investors, whereas the majority of investors in the securities of affected funds are retail investors, who may face relatively higher costs associated with searching for information distributed across multiple documents."). Today's Adopting Release also cites studies that show that institutional holding is approximately 30% for BDCs and only 21% for closed-end funds, compared to institutional ownership of public U.S. equities of approximately 67%. *Id.* at n.409.

[10] *See* BDC-CEF Offering Reform Proposing Release, *supra* note 9, at 97-104.

[11] *Id.* at 108-112 ("Information about an affected fund's investment objectives or policies, such as the types of instruments and investment practices it uses, is important to prospective investors and current shareholders to help inform their investment decisions . . . Given the importance of this information to investors, we are proposing to require current disclosure about a material change in an affected fund's investment objectives or policies.").

[12] *Id.* at 112-120 ("We believe a material decline in the valuation of one or more significant investments of an affected fund would be important to investors. Such a decline would likely have a significant impact on the value of an investment in the fund. Further, unlike open-end funds, which must maintain sufficiently liquid assets in order to provide daily redemptions (and generally must limit their investments in illiquid securities to 15% of the fund's assets), affected funds often invest more significantly in less liquid investments where there is less publicly-available information surrounding events that may impact valuations.").

[13] *Id.* at 105 ("We are proposing amendments to Form 8-K as it relates to affected funds to improve current reporting of important information by affected funds to investors and the market. We believe it is appropriate to propose certain new reporting items that would apply to all affected funds to better tailor Form 8-K disclosure to these types of investment companies. We believe these amendments enhance parity between affected funds and operating companies that are able to take advantage of the registration, communications, and offering rules in the

2005 securities offering reforms with respect to the amount of current information available to investors, consistent with the overall intent of the Registered CEF and BDC Acts.").

[14] In fact, the Commission specifically determined in 2005 that the benefits of securities offering reform should not be available to voluntary 8-K filers and that "such issuers should be required to register under the Exchange Act, and thus become subject to all of the results of registration for all purposes, if they wish the avail themselves of" the benefits. *See* 2005 Securities Offering Reform Adopting Release, *supra* note 1, at 37. *See also* BDC-CEF Offering Reform Adopting Release, *supra* note 1, at n.307.

[15] Specifically, the final rules will allow continuously offered BDCs and closed-end funds to rely on Rule 486(a) for post-effective amendments to become effective automatically 60 days after filing with the Commission. *See* BDC-CEF Offering Reform Adopting Release, *supra* note 1, at 52-59. *See also* 17 C.F.R. § 230.486(a).

[16] *See* 17 C.F.R. § 230.486(b). Rule 486(b) allows a fund to amend its registration statement on an immediate and automatically-effective basis only with respect to certain routine updates which include, among others: registering additional shares of common stock; bringing financial statements up to date; and making other non-material changes. *Id*.

[17] The Securities Act of 1933 ("Securities Act") specifically empowers the Commission to determine the date of effectiveness of a post-effective amendment. *See* Section 8(c) of the Securities Act, 15 U.S.C. § 77h ("An amendment filed after the effective date of the registration statement, if such amendment, upon its face, appears to the Commission not to be incomplete or inaccurate in any material respect, shall become effective on such date as the Commission may determine, having due regard to the public interest and the protection of investors."). This enables the Commission—and the staff acting on behalf of the Commission—to ensure that an amendment is both complete and accurate, and that its contents do not undermine the public interest or protection of investors. While the staff will still have an opportunity to review and comment on the material changes during a 60-day window, effectiveness of any material changes will no longer require staff or Commission action.

[18] While many funds will, of course, continue to work with the staff in good faith to resolve open issues, there will be no legal requirement for them to do so, and that leaves the Commission with far fewer options, such as the use of a stop order, which is a tool that is rarely used.