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# New Rules, Proposed Rules, Guidance and Alerts

## GUIDANCE AND ALERTS

### SEC's Division of Examinations Issues Risk Alert on ESG Investing

On April 9, 2021, the SEC's Division of Examinations (formerly the Office of Compliance Inspections and Examinations) issued a risk alert highlighting the staff's observations from recent examinations of investment advisers, registered investment companies and private funds offering environmental, social and governance (ESG) products and services. In light of the increased investor demand for ESG products and services and the variability of ESG definitions and terms, the risk alert elaborates on the focus of future examinations, as well as on deficiencies and best practices observed in past examinations.

The staff stated that future examinations of firms engaging in ESG investing will focus on, among other things, the following:

- The firm's policies, procedures and practices related to ESG investing and the use of ESG-related terminology, including the processes for ensuring that the selection of investments and proxy voting are consistent with ESG disclosures and marketing materials;
- The firm's regulatory filings, websites, reports to any sponsors of global ESG frameworks the firm has committed to follow, client presentations, responses to due diligence questionnaires, requests for proposals and client/investor-facing documents; and
- The firm's compliance policies and procedures and their implementation, as well as compliance oversight and the review of ESG investing practices and disclosures.

The staff found the following deficiencies in its examinations of firms engaging in ESG investing:

- Portfolio management practices that were inconsistent with ESG disclosures;
- Inadequate controls regarding ESG-related investing guidelines, mandates and restrictions;
- Proxy voting that was inconsistent with stated ESG approaches;
- Unsubstantiated or misleading claims regarding ESG approaches;
- Inadequate controls to ensure consistency between actual firm practices and ESG-related disclosures and marketing;
- Lack of policies and procedures addressing ESG investing analyses, decision-making processes or compliance review and oversight; and
- Compliance personnel with limited knowledge of ESG-investment analyses, resulting in less effective compliance programs.

In contrast to such deficiencies, the staff observed the following effective practices related to ESG investing:

- Clear and precise disclosure that has been tailored to the firm's specific approach to ESG investing and that is aligned with the firm's actual practices;
- Detailed policies and procedures that address ESG investing, including specific documentation to be completed at various stages of the investment process; and
- Knowledgeable compliance personnel who are integrated into the firm's ESG-related processes.

In light of these observations, the staff advised firms to review their disclosures and other public statements to ensure that they are consistent with the firm's practices, to ensure the consistent application of ESG investing principles throughout the firm and that these principles are adequately addressed in the firm's compliance program, and to document and maintain records relating to the ESG investing process.

The risk alert is available here.

### SEC Reaffirms Guidance for Conducting Shareholder Meetings during Pandemic

On April 9, 2021, the staff of the SEC's Divisions of Corporation Finance and Investment Management reaffirmed previous guidance for holding shareholder

meetings during the COVID-19 pandemic. Given the health, transportation and logistical challenges and other issues raised by the pandemic in the spring of 2020, the SEC staff's guidance provided issuers with flexibility to, among other things, change the date, time or location of a shareholder meeting without mailing additional soliciting materials or amending proxy materials, subject to certain conditions, such as issuing a press release announcing such change.

The SEC staff's prior guidance—issued on April 7, 2020—remains in effect and unchanged; the presentation of shareholder proposals is the only topic with updated guidance. In light of the possible continued difficulties for shareholder proponents to attend annual meetings in person to present their proposals, the SEC staff encourages issuers, to the extent feasible under state law, to provide shareholder proponents or their representatives with the ability to present their proposals through alternative means, such as by phone, during the 2021 proxy season. Moreover, as previously noted by the SEC staff, to the extent a shareholder proponent or representative is not able to attend the annual meeting and present the proposal due to the inability to travel or other hardships related to COVID-19, the staff would consider this to be "good cause" under Rule 14a-8(h) should issuers assert Rule 14a-8(h)(3) as a basis to exclude a proposal submitted by the shareholder proponent for any meetings held in the following two calendar years.

The SEC staff's guidance is available here.

## SEC's Division of Examinations Issues Risk Alert Cautioning Firms to Comply with Suspicious Activity Monitoring and Reporting

On March 29, 2021, the SEC's Division of Examinations (formerly, the Office of Compliance Inspections and Examinations) issued a risk alert reminding broker-dealers of their anti-money laundering (AML) compliance obligations pursuant to the Bank Secrecy Act, rules of the U.S. Department of the Treasury's Financial Crimes Enforcement Network (FinCEN) and Rule 17a-8 under the Securities Exchange Act of 1934. The risk alert notes that mutual funds also may benefit from the examination observations addressed by the staff.

The risk alert primarily discusses compliance with the "AML Program Rule" and "SAR Rule," which FinCEN adopted in 2002. Under the AML Program Rule, broker-dealers are required to establish and implement policies, procedures and internal controls reasonably designed, among other things, to identify and report suspicious transactions. Under the SAR Rule, broker-dealers are required to file with FinCEN a suspicious activity report (SAR) regarding any suspicious transaction of $5,000 or greater that could be a possible violation of law.

In issuing the risk alert, the staff seeks to remind broker-dealers of their obligations under AML rules, assist firms in reviewing and enhancing their AML programs, and provide observations of recent examinations of other broker-dealers and specific recommendations regarding compliance with the AML Program Rule and SAR Rule. FINRA has previously provided similar guidance in Notice to Members 02-21 and, more recently, in Regulatory Notice 19-18.

The risk alert provides the following specific recommendations:

### Observations Related to the AML Program Rule

- Broker-dealers must establish policies, procedures and internal controls reasonably designed to identify and report suspicious transactions. The staff observed that certain firms (i) did not list "red flags" in their procedures that would assist personnel in identifying suspicious activity (e.g., transactions in low-priced securities), (ii) failed to have automated systems to monitor large trading volumes but rather relied upon manual reviews and did not seek to identify trends or patterns across multiple accounts, (iii) failed to adequately monitor transactions in "penny stocks," focusing on securities priced under $1 per share without evaluating securities priced between $1 and $5 per

share and (iv) improperly deferred their AML obligations to their clearing firms.

- Broker-dealers must implement these policies and procedures. The staff observed certain firms that did not conduct adequate due diligence on or report suspicious activity that would have triggered an SAR filing requirement under the firm's procedures. In particular, firms did not follow up on red flags, such as prearranged or non-competitive trading, including wash sales or potential insider trading.

### Observations Related to the SAR Rule

- Broker-dealers must file SARs if they know, suspect or have reason to suspect that the broker-dealer was used to facilitate unlawful activity. The staff again highlighted activity in low-priced securities as an area where firms must be especially vigilant in addressing red flags conducting due diligence and filing SARs. Among other red flags, firms did not follow up on deposits and subsequent liquidations of low-priced securities, patterns of trading activity common to several customers, particularly in low-priced securities, trading in thinly traded securities and trading by customers with questionable backgrounds and subject to prior securities laws violations.

- Broker-dealers must file accurate and complete SARs and include key details known to the firm of individual customer trades or issuers, and use the specific structured data fields on the SAR. In particular, the staff observed that firms used generic, boilerplate language, without providing detailed information making clear the true nature of the suspicious activity.

The risk alert is available here. The risk alert includes hyperlinks to a number of helpful resources from the SEC staff, FINRA, FinCEN and the G7's Financial Action Task Force.

## FINRA Issues Guidance on Sales Charge Discounts and Waivers for Investment Company Products

On March 4, 2021, FINRA issued a regulatory notice relating to the application of investment company sales charge discounts and waivers to investors in circumstances described in applicable offering documents. The notice is intended to remind firms that they are obligated to understand sales charge discounts and waivers available on the products they offer and to apply them to eligible investors. The notice also provides an overview of sales charge discounts and waivers common in the industry, including volume-based sales charge discounts (i.e., breakpoints) and sales charge waivers; notes certain frequently observed findings from FINRA examinations and enforcement actions; and reviews certain items firms should consider to improve compliance.

In the notice, FINRA identified certain recurring themes encountered in examinations and enforcement actions with respect to sales charge waivers and discounts, including:

- firms whose systems, controls and written supervisory procedures were inadequate to identify customers eligible for sales charge discounts or waivers;
- firms that relied on associated persons to identify and apply sales charge discounts and waivers but failed to provide adequate training regarding the availability of those discounts and waivers; and
- that the foregoing problems were often compounded when associated persons were permitted to sell mutual funds to customers with accounts held directly with the funds' transfer agents as a result of firms not having adequate systems in place to capture relevant data to supervise direct business transactions.

The notice also includes an extensive list of questions intended to assist firms in evaluating the adequacy of supervisory systems, written supervisory procedures and training programs relating to the application of sales charge discounts and waivers.

FINRA's notice is available here.

## OTHER DEVELOPMENTS

### SEC Staff of Division of Investment Management Issues Statement on Registered Funds Investing in Bitcoin Futures

On May 11, 2021, the staff of the SEC's Division of Investment Management issued a statement regarding the staff's current views on registered funds investing in bitcoin futures. On May 14, 2021, W. Thomas Conner and Jeremy I. Senderowicz of Vedder Price's Investment Services Group published an article summarizing the staff's statement and providing certain takeaways.

The Vedder Price article is available here.

### SEC Publishes List of Rules Scheduled for Review under Regulatory Flexibility Act

On March 17, 2021, the SEC published a list of rules scheduled for review pursuant to Section 610 of the Regulatory Flexibility Act (RFA), which requires an agency to review its rules that have a significant impact upon a substantial number of small entities within ten years of the final rule's publication. The rules which will be assessed, including to determine whether such rules should be continued without change, amended or rescinded, include the following:

- Reporting by investment advisers to private funds and certain commodity pool operators and commodity trading advisors on Form PF;
- The pay-to-play rule;
- Registration requirements for advisers to venture capital funds and small private fund advisers; and
- Family office registration exemptions.

Review of a rule pursuant to the RFA does not necessarily mean that future rulemaking is imminent. Nonetheless, under the RFA, specific consideration must be given to the following factors when assessing a rule:

- The continued need for the rule;
- The nature of complaints or comments received concerning the rule from the public;
- The rule's complexity;
- The extent to which the rule overlaps, duplicates or conflicts with other federal rules, and, to the extent feasible, with state and local governmental rules; and
- The length of time since the rule has been evaluated or the degree to which technology, economic conditions, or other factors have changed in the area affected by the rule.

The list of rules scheduled for review is available here.

# Enforcement and Litigation Matters

## LITIGATION MATTERS

### Massachusetts Court Denies Motion to Dismiss Certain Counterclaims Regarding Closed-End Fund Bylaw Amendments

On March 31, 2021, the Suffolk County Superior Court in Massachusetts issued a ruling on a motion to dismiss various counterclaims in a suit originally filed on July 15, 2020 by Eaton Vance Senior Income Trust, a registered closed-end fund organized as a Massachusetts business trust, against Saba Capital Master Fund, Ltd., a shareholder of the fund, seeking a declaratory judgment that a previously adopted amendment to the fund's bylaws is valid. In its ruling, the court dismissed certain counterclaims asserted by Saba but allowed other counterclaims to proceed.

At issue are certain bylaw amendments adopted by four Eaton Vance-sponsored closed-end funds that are organized

as Massachusetts business trusts. The Trusts sought a declaratory judgment that a bylaw amendment providing that in a contested election a trustee nominee must receive the affirmative vote of a majority of the fund's outstanding shares, but in an uncontested election a trustee nominee need receive only the affirmative vote of a plurality of the votes cast. Prior to the amendment, the plurality standard applied to all trustee elections, contested and uncontested. The amendment also provided that if neither an incumbent nor a new trustee nominee receives the required majority vote in a contested election, the incumbent trustee may continue to serve (the election bylaw). In response, Saba Capital Master Fund, Ltd., an investor in the funds, challenged the validity of that amendment as well as a second bylaw amendment, similar in operation to "control share" provisions under state corporate laws, providing that a shareholder that acquires the ownership or control of more than 10 percent of the voting power of a fund may not vote its shares without special authorization to do so by a majority vote of the fund's shareholders (the control share bylaw). In addition, Saba asserted certain other counterclaims against the funds, their trustees and their investment adviser and sought a declaratory judgment that both bylaw amendments are invalid.

In its ruling, the court dismissed Saba's counterclaims against the funds and their trustees alleging breach of the implied covenant of good faith and fair dealing and two counterclaims against the funds' investment adviser alleging tortious interference with contractual relations and aiding and abetting a breach of fiduciary duty. However, the court denied the motion to dismiss Saba's counterclaims alleging breach of contract and breach of fiduciary duty, as well as Saba's counterclaims seeking rescission of the control share bylaw under the Investment Company Act of 1940 and a declaratory judgment as to the validity of the bylaw amendments, allowing those claims to continue.

As stated by the court in this case, to survive a motion to dismiss, a party must simply allege facts that, if true, would "plausibly suggest[ ] . . . an entitlement to relief." Accordingly, in considering the motion to dismiss Saba's claims, the court assumed the accuracy of Saba's factual allegations and drew "all reasonable inferences" in favor of Saba.

With respect to Saba's breach of contract claims, Saba asserted that the declarations of trust that govern the funds are contracts between the funds and their shareholders, and that adoption of the bylaw amendments in question breach that contract. In particular, with respect to the election bylaw, Saba alleged that requiring a trustee to be elected by a majority vote in a contested election makes it "impossible in practice" for a shareholder to challenge the reelection of a sitting trustee because, as Saba claimed in its memorandum of law, "a significant proportion of the shareholders in closed-end funds" do not vote. Accordingly, Saba claimed that this bylaw amendment violated the declaration of trust provision giving shareholders the right to remove trustees. With respect to the control share bylaw, Saba asserted that this amendment deprived shareholders owning more than 10 percent of a fund's outstanding shares of their right to vote, in violation of a declaration of trust provision stating that "Shareholders shall have power to vote . . . with respect to the election of Trustees" and "for the removal of Trustees." Assuming the accuracy of Saba's factual allegations, the court determined that these claims could survive the motion to dismiss.

Saba also asserted that the funds' trustees breached applicable fiduciary duties by adopting the bylaw amendments in question. Although the trustees asserted that they owe a fiduciary duty to the funds but not the funds' shareholders, the court agreed with Saba's assertion that, unless otherwise provided in the declaration of trust, the trustees of a Massachusetts business trust owe fiduciary duties to the trust's beneficiaries. The trustees asserted that their actions should be provided deference under the "business judgment rule," which shields from liability directors who make decisions "in good faith [and] with the care that a person in a like position would reasonably believe appropriate in similar circumstances," that the director "reasonably believes to be in the best interests of the corporation." Saba alleged that in adopting the bylaw

amendments, the funds' trustees had not acted in good faith and in the funds' best interests but rather acted to prevent Saba from removing them from office and to protect their own interests and the interests of the funds' investment adviser. Assuming this allegation to be true, the court determined that the breach of fiduciary duty claim could survive the motion to dismiss.

Finally, Saba claimed that the control share bylaw violates Section 18 of the 1940 Act, which generally provides that "every share of stock . . . issued by a registered management company . . . shall be a voting stock and have equal voting rights with every other outstanding voting stock . . . ." Saba further asserted that because the funds' bylaws are contracts between the funds and their shareholders, and because Section 46 of the 1940 Act provides that any contract that violates the 1940 Act is unenforceable and subject to rescission, that the control share bylaw should be rescinded. Assuming the accuracy of Saba's allegation, the court determined that the claim asserting a breach of the 1940 Act could survive the motion to dismiss.

The court's memorandum and order is available under the caption *Eaton Vance Senior Income Trust v. Saba Capital Master Fund, Ltd.,* 2084CV01533-BLS2 (Mass. Super. Ct. Mar. 31, 2021).

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# VedderPrice

## Investment Services Group

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