

## SEC/SRO UPDATE: SEC PROPOSES TO IMPROVE THE RETAIL INVESTOR EXPERIENCE THROUGH MODERNIZED FUND SHAREHOLDER REPORTS AND DISCLOSURES; SEC MODERNIZES THE ACCREDITED INVESTOR DEFINITION; SEC ADOPTS RULE AMENDMENTS TO MODERNIZE DISCLOSURES OF BUSINESS, LEGAL PROCEEDINGS, AND RISK FACTORS UNDER REGULATION S-K; SEC CHARGES PONZI SCHEME TARGETING AFRICAN IMMIGRANTS

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### SEC Proposes to Improve the Retail Investor Experience through Modernized Fund Shareholder Reports and Disclosures

On August 5, the Securities and Exchange Commission (the “SEC” or “Commission”) proposed modifications to the mutual fund and exchange-traded fund disclosure framework that, if adopted, “would feature concise and visually engaging share-

holder reports that would highlight information that is particularly important for retail investors to assess and monitor their fund investments.”<sup>1</sup>

The proposal would:

- require streamlined shareholder reports that would include, among other things, fund expenses, performance, illustrations of holdings, and material fund changes;
- significantly revise the content of these items to seek to better align disclosures with developments in the markets and investor expectations;
- encourage funds to use graphic or text features—such as tables, bullet lists, and question-and-answer formats—to promote effective communication; and
- promote a layered disclosure framework by continuing to make available online certain information that is currently required in shareholder reports but may be less relevant to retail shareholders generally.

Under the proposed framework, instead of receiving both prospectus updates and shareholder reports, current investors would receive the streamlined shareholder report. Information currently required in shareholder reports that is not included in the streamlined shareholder report would be available online, delivered free of charge upon request, and filed on a semi-annual basis with the Commission.

In addition, the proposal would amend prospectus disclosure requirements to seek to provide greater clarity and more consistent information regarding fees, expenses, and principal risks. To seek to improve fee- and expense-related information more broadly, the proposal would also amend investment company advertising rules with the goal of promoting more transparent and balanced statements about investment costs. The proposed advertising rule

amendments would affect all registered investment companies and business development companies.

Under the existing framework, beginning as early as January 1, 2021, funds may begin relying on Rule 30e-3. This current rule generally permits funds to satisfy shareholder report transmission requirements by making these reports and other materials available online and providing a notice of the reports' online availability, instead of directly providing the reports to shareholders. Investors who prefer to receive the full reports in paper may—at any time—choose that option free of charge. The proposed rule would amend the scope of Rule 30e-3 to exclude open-end funds, but would not affect the availability of Rule 30e-3 for other registered management companies (such as registered closed-end funds) or registered unit investment trusts.

The public comment period will remain open for 60 days after publication in the Federal Register.

### SEC Modernizes the Accredited Investor Definition

On August 26, the Commission expanded the definition of “accredited investor” under Rule 215 and Rule 501(a) of the Securities Act of 1933 (the “Securities Act”), allowing more investors to participate in private offerings of securities.<sup>2</sup> The amendments are part of the Commission’s broader effort to “simplify, harmonize, and improve the exempt offering framework under the Securities Act to promote capital formation and expand investment opportunities while maintaining and enhancing appropriate investor protections.”<sup>3</sup>

#### Background

Under the Securities Act, any offer or sale of securities must be registered with the Commission or meet an exemption from registration. The definition of “accredited investor” has been a central component of a number of exemptions, including Rule

506(b) and Rule 506(c) of Regulation D of the Securities Act. Prior to the final amendments, individual accredited investors were only those who were directors, executive officers or general partners of the issuer, or a general partner of a general partner of that issuer, or met certain income or net worth thresholds (*e.g.*, an individual with a net worth (or joint net worth with that person’s spouse) exceeding \$1,000,000, or an individual with income in excess of \$200,000 in each of the two most recent years (or joint income with that person’s spouse in excess of \$300,000 in each of the two most recent years)).<sup>4</sup>

In the final amendments, the Commission stated that it no longer believes that “wealth should be the sole means of establishing financial sophistication of an individual for purposes of the accredited investor definition.”<sup>5</sup> The final amendments are intended to “identify more effectively investors that have sufficient knowledge and expertise to participate in investment opportunities that do not have the rigorous disclosure and procedural requirements, and related investor protections, provided by registration under the Securities Act of 1933.”<sup>6</sup>

#### Final Amendments

The final amendments add the following categories of individuals to the definition of “accredited investor”:<sup>7</sup>

- *Designated Professionals.* Individuals who hold professional certifications, designations, or credentials from accredited educational institutions. The Commission may designate from time to time which certifications, designations, or credentials qualify (a nonexclusive list of attributes that the Commission will consider is included in the final amendments). As of August 26, the Commission has designated Series 7, Series 65, and Series 82 licenses as qualifying under this change.
- *Knowledgeable Employees.* Individuals who

are knowledgeable employees of a private fund. The definition of “knowledgeable employee” is defined in Rule 3c-5(a)(4) of the Investment Company Act of 1940 and includes: executive officers, directors, trustees, general partners, advisory board members, or persons serving in a similar capacity, of a Section 3(c)(1) or 3(c)(7) private fund, or an affiliated person of the fund who oversees the fund’s investments, as well as employees or affiliated persons of the private fund (other than employees performing solely clerical, secretarial or administrative functions) who, in connection with such employees’ regular functions or duties, have participated in the investment activities of such private fund for at least 12 months.

- *Investment Advisers.* SEC- and state-registered investment advisers and exempt reporting advisers, regardless of total assets under management.
- *Rural Business Investment Companies (RBICs).* RBICs are similar to small business investment companies, which were already included in the definition of “accredited investor.”
- *Limited Liability Companies.* A limited liability company with assets in excess of \$5,000,000 that was not formed for the specific purpose of investing in the securities being offered. This is intended to clarify the SEC’s historical but unofficial interpretation of such entities as accredited investors.
- *Family Offices and Family Clients.* Family offices, as defined by the “family office rule” in Rule 202(a)(11)(G)-1 of the Investment Advisers Act of 1940 with at least \$5,000,000 in assets under management, not formed for the specific purpose of investing in the securities

being offered, and its prospective investment is directed by a person with who has such knowledge and experience in financial and business matters that such family office is capable of evaluating the merits and risks of the prospective investment. Family clients, whose prospective investment in the issuer is directed by such family office, will also be included in the definition of “accredited investor.”

- *Catch-all.* Entities that are formed for any purpose other than investing in the securities being offered and have investments in excess of \$5,000,000. This “catch-all” addition to the definition of “accredited investor” is intended to include Indian tribes, governmental bodies, funds, and entities organized under the laws of foreign countries.
- *Spousal Equivalent.* When calculating joint income under Rule 501(a)(6) or joint net worth under Rule 501(a)(5), a cohabitant occupying a relationship equivalent to that of a spouse may be included in such calculation.

The Commission declined to index to inflation the financial thresholds for net worth or income. Such financial thresholds have remained unchanged since 1982.

The final amendments also expand the definition of “qualified institutional buyer” under Rule 144A of the Securities Act to conform to the changes made to the definition of “accredited investor.”<sup>8</sup>

The final amendments will become effective 60 days after publication in the Federal Register.

### **SEC Adopts Rule Amendments to Modernize Disclosures of Business, Legal Proceedings, and Risk Factors under Regulation S-K**

On August 26, for the first time in over 30 years, the SEC adopted substantive rule amendments to

modernize the description of business (Item 101), legal proceedings (Item 103), and risk factors (Item 105) disclosures that companies are required to make pursuant to Regulation S-K.<sup>9</sup> The SEC staff noted in its press release that the amendments are “intended to elicit improved disclosures, tailored to reflect registrant’s particular circumstances, which are designed will [sic] improve disclosures for investors and add efficiencies to the compliance efforts of registrants.”<sup>10</sup> A summary of the adopted amendments is provided below:<sup>11</sup>

Description of Business—General Development (Item 101(a)): The final amendments, among other things:

- make the general development disclosure a more principles-based disclosure of information and include a non-exclusive list of the types of information that a company may need to disclose to the extent such information is material to understanding the general development of a company’s business;
- eliminate the five-year disclosure timeframe and focus instead on material developments of a company’s business, regardless of a specific timeframe; and
- permit a company, after the filing of its initial registration statement, to provide only updated disclosures of material developments of the business since its most recent full discussion of the development of the business, and incorporate by reference that prior full discussion.

Description of Business—Narrative Description (Item 101(c)): The final amendments, among other things:

- provide a non-exclusive list of disclosure topics drawn in part from a subset of the topics currently contained in Item 101(c);

- require, to the extent material, new disclosures regarding “human capital resources,” including any human capital measures or objectives that a company’s management team focuses on in managing the business, such as, depending on the nature of the company’s business and workforce, measures or objectives that address the attraction, development, and retention of personnel; and
- expand the current requirement to disclose the impact of environmental regulations to cover all material government regulations, not just environmental laws.

Legal Proceedings (Item 103): The final amendments, among other things:

- clarify that required information about material legal proceedings may be provided by including hyperlinks or cross-references to legal proceedings disclosed elsewhere in the document (*e.g.*, notes to the financial statements) to avoid repetitive disclosure; and
- increase the threshold for environmental proceedings involving governmental parties from \$100,000 to \$300,000, but give flexibility to a company to select a different threshold that it determines is reasonably designed to result in disclosure of material environmental proceedings (provided that the adopted threshold does not exceed the lesser of \$1,000,000 or 1% of the current assets of the company).

Risk Factors (Item 105): The final amendments, among other things:

- require a summary of the risk factors section if it exceeds 15 pages;
- replace the requirement to disclose the “most significant” risk factors with “material” risk factors to focus on risks that are important to

investors in making an investment decision; and

- require risk factors to be organized under relevant headings, with any risk factors generally applicable to an investment in securities disclosed at the end of the risk factors section under a separate caption, to help investors better understand lengthy risk factors disclosures.

The final amendments will be effective 30 days after publication in the Federal Register.

### SEC Charges Ponzi Scheme Targeting African Immigrants

On August 28, the Commission charged two Maryland companies and three of their principals for a scheme that allegedly defrauded approximately 1,200 investors, many of them African immigrants, of more than \$27 million.<sup>12</sup>

According to the SEC's complaint, these principals, directly and through their companies 1st Million LLC and The Smart Partners LLC, falsely told investors that their funds would be used by a team of skilled and licensed traders for foreign exchange and cryptocurrency trading, promising risk-free returns of between 6% and 42%. The complaint alleges that the defendants often targeted vulnerable African immigrants and exploited their common ancestry and religious affiliations. The complaint further alleges that one of the principals, who claimed to be a pastor and falsely held himself out as a self-made millionaire and expert trader, rented office space to conduct in-person meetings and give the appearance of a legitimate company. According to the complaint, the defendants diverted investor funds for personal use and to make Ponzi payments to prior investors.

In parallel actions, the U.S. Attorney's Office for the District of Maryland today announced the filing of criminal charges and the U.S. Commodity Futures Trading Commission ("CFTC") filed a civil action.

The SEC's complaint, filed in federal court in Greenbelt, Maryland, charges the defendants with violating the antifraud provisions of the federal securities laws and seeks permanent injunctive relief, return of allegedly ill-gotten gains with prejudgment interest, and civil penalties. The SEC also named Access2Assets as a relief defendant, seeking the return of proceeds of the alleged fraud to which it had no legitimate claim.

The SEC's Office of Investor Education and Advocacy encourages investors to review the Investor Alerts on affinity fraud, *Have Something in Common with Someone Selling an Investment? It May Make You a Target for Fraud and Avoiding Investment Fraud in Your Faith-Based Community*, and to access the investor protection resources at Investor.gov. Investors can also learn more about Ponzi scheme red flags and check out the background of their investment professional by using the free and simple search tool at the SEC's Investor.gov website.

### ENDNOTES:

<sup>1</sup>See SEC Press Rel. No. 2020-172 (Aug. 5, 2020), available at <https://www.sec.gov/news/press-release/2020-172>. See also SEC Rel. No. 33-10814 (Aug. 5, 2020), available at <https://www.sec.gov/rules/proposed/2020/33-10814.pdf> (proposed rule) and [https://www.sec.gov/files/final\\_2020\\_im\\_annual-shareholder%20report.pdf](https://www.sec.gov/files/final_2020_im_annual-shareholder%20report.pdf) (hypothetical streamlined shareholder report).

<sup>2</sup>See SEC Press Rel. No. 2020-191 (Aug. 26, 2020), available at <https://www.sec.gov/news/press-release/2020-191>.

<sup>3</sup>See SEC Rel. No. 33-10824 and 34-89669 (Aug. 26, 2020), at 4, available at <https://www.sec.gov/rules/final/2020/33-10824.pdf>.

<sup>4</sup>See 17 C.F.R. § 230.501(a).

<sup>5</sup>See SEC Rel. No. 33-10824 and 34-89669 (Aug. 26, 2020), at 6, available at <https://www.sec.gov/rules/final/2020/33-10824.pdf>.

<sup>6</sup>SEC Rel. No. 33-10924, 34-89669 at 1.

<sup>7</sup>SEC Rel. No. 33-10924, 34-89669 at 1.

<sup>8</sup>SEC Rel. No. 33-10924, 34-89669 at 1.

<sup>9</sup>See SEC Press Rel. No. 2020-192 (Aug. 26, 2020), available at <https://www.sec.gov/news/press-release/2020-192>.

<sup>10</sup>No. 2020-192.

<sup>11</sup>See SEC Rel. No. 33-10825 and 34-89670, available at <https://www.sec.gov/rules/final/2020/33-10825.pdf>.

<sup>12</sup>See SEC Press Rel. No. 2020-198 (Aug. 28, 2020), available at <https://www.sec.gov/news/press-release/2020-198>.