Registered Funds

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Exchange-Traded Funds (ETFs)

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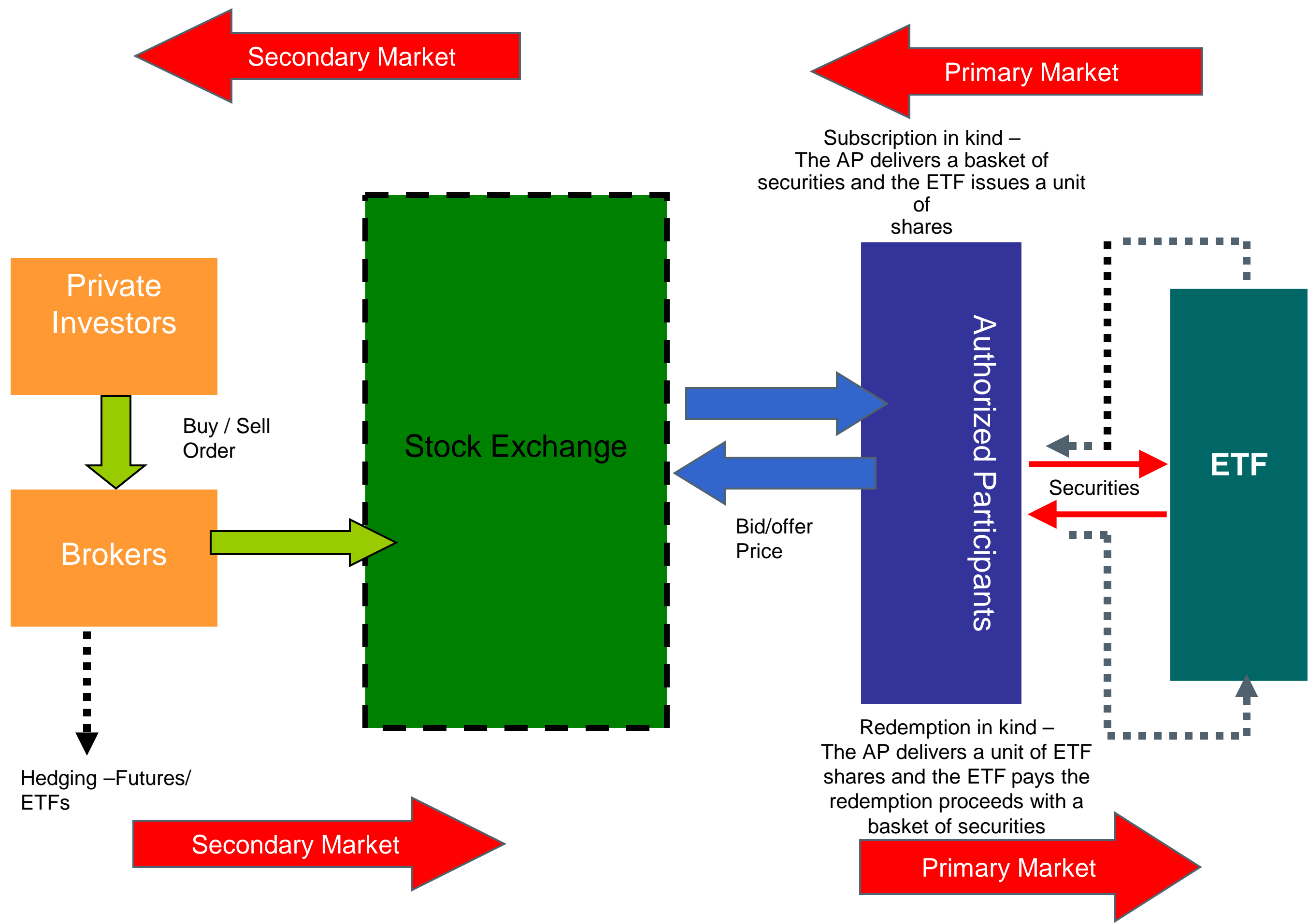
WHY ARE ETFS SOMETIMES REFERRED TO AS ETVS?

- ETVs – exchange-listed equity securities
  - ETVs: Generic term
  - ETPs: Commodity funds, currency funds
  - ETFs: Registered funds
- *Not* ETNs
  - Unsecured, debt securities
    - *Unlike ETVs, ETNs are not equity securities*

HOW DO ETFS WORK?



HOW DO ETFS WORK?

- ETFs sell and redeem their shares at NAV *directly* to unaffiliated broker-dealers with whom the ETF has entered into an agreement ("Authorized Participants")
- These "primary market" transactions occur in large blocks of (at least 25,000) shares called "Creation Units"

HOW DO ETFS WORK?

- Authorized Participants purchase and redeem Creation Units in-kind in exchange for the "Creation Basket"
  - *Pro rata* slice requirement
  - Exceptions to *pro rata* slice requirement
  - "Custom" baskets
- Authorized Participants (who purchase Creation Units) sell individual ETF shares on the stock exchange

HOW DO RETAIL INVESTORS BUY ETFS?

- These transactions take place on the exchange between investors and their brokers and don't involve the ETF itself

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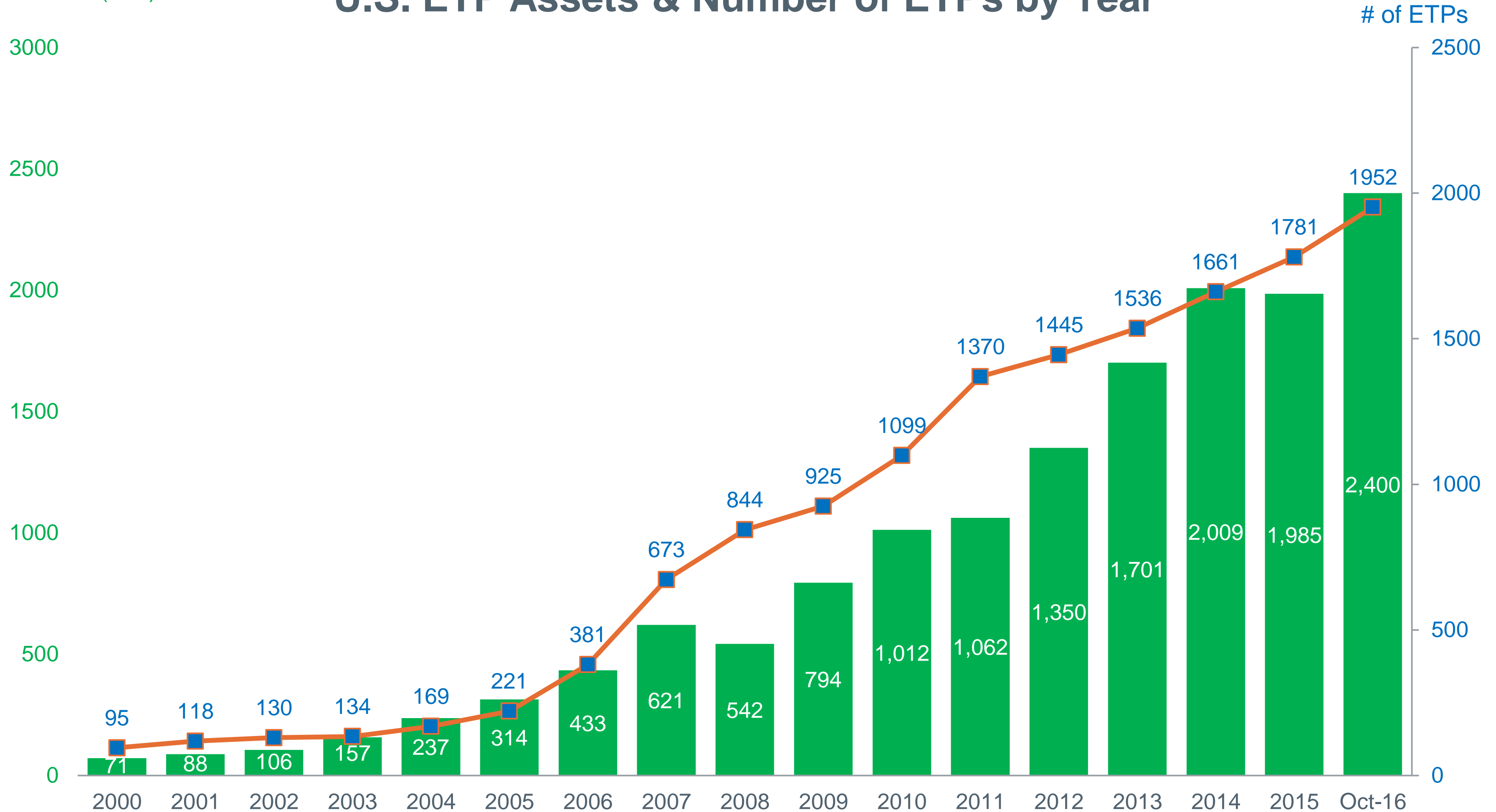
LIQUIDITY RULE - IMPACT ON ETFs

- Liquidity Risk Management Program for ETFs
  - Assess, manage and review liquidity risk using ETF-related factors
  - Assign 1of 4 “days-to-cash” buckets to each investment
  - Establish a highly liquid investment minimum
  - Stay below 15% limitation on illiquid investments
  - Provide disclosures on N-1A, N-PORT, N-CEN, N-LIQUID
- Exception = “In-Kind ETF”
  - Using more than *de minimis* amount of cash to meet redemptions disqualifies designation as In-Kind ETF
  - Liquidity Risk Management Program required with carveouts
    - No requirement to assign investments to 1 of 4 “days-to-cash” buckets
    - No requirement of highly liquid investment minimum
  - Must report designation as an In-Kind ETF on Form N-CEN

BUSINESS CONSIDERATIONS



BUSINESS CONSIDERATIONS

ETFs' popularity

- Changes in distribution models have increased demand by RIAs
  - Lower Expenses
    - Enhanced returns
  - Transparency
  - Tax Efficiency
  - Investor Protections
    - Intra-day liquidity
    - Market timing

Hurdles to market entry

- Increased Regulatory Scrutiny
  - Market structure issues
- Strategy considerations
  - Passive market saturated
  - Active ETF issues
    - Small market segment
    - Portfolio transparency
    - Potential regulatory delays
  - "Smart-beta" alternatives
  - Non-transparent active ETFs

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PERSPECTIVES ON INDEXING

- The future of indexing
- Affiliated index providers
- "Smart Beta" or Bespoke Indexing
  - Quantitative, normally, investment strategies
  - Reduced to algorithm
  - Full portfolio disclosure
- Variation: Index committee replaces algorithm
  - Potential for "closet" active management
  - SEC position

IS NON-TRANSPARENT ACTIVE VIABLE?

- Non-Transparent Active ETF Hallmarks
  - Transparency substitute
  - Tax-efficiency

IS NON-TRANSPARENT ACTIVE VIABLE?

- Precidian Proposal (“Blind Trust”)
  - IIV and “Reinforcement Learning”
- SEC Preliminary Denial
  - IIV
    - Stale (every 15 seconds)
    - Unreliable (no standard calculation methodology)
  - Reinforcement Learning
    - Statistical arbitrage
- Prologue: VIIV
  - Withdrawn by Precidian

IS NON-TRANSPARENT ACTIVE VIABLE?

- Transparency Substitute
  - Tracking Portfolio
    - NYSE Arca (formerly AMEX) “Black Box”
  - Partial Transparency
    - Vanguard
    - T. Rowe Price

SEC CONCERNS

Transparency substitute

- Arbitrage mechanism

"A close tie between market price and NAV per share of the ETF is the foundation for why the prices at which retail investors buy and sell ETF shares are similar to the prices at which Authorized Participants are able to buy and redeem shares directly from the ETF at NAV."

- Statistical arbitrage
  - Market volatility
- Misleading baskets
- Front-running/free-riding

Tax efficiency

- Role in 6(c) findings
  - "necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the [Act]"

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OTHER STRUCTURES

"ETMFS" (EATON VANCE)

- NAV-based trading
  - No intra-day pricing
  - No intra-day market risk for APs
  - Limited need for an arbitrage mechanism

"Because Share trading prices are based on end-of-day NAV, a market maker holding positions in Shares is not exposed to intraday market risk. Whether an ETMF's underlying value goes up or down over the course of a trading day will not affect how much profit a market maker earns by selling (or buying) Shares in the market at a net premium (discount) to NAV… No intraday market risk means no requirement for intraday hedging, and therefore no associated requirement for the market maker to know the current composition of the ETMF's non-Basket holdings."

"ETAFS" (FIDELITY)

- Closed-end fund with weekly repurchase offers
  - No need for relief from Section 22(d) and Rule 22c-1
  - Reduced pressure on effectiveness of arbitrage mechanism

Selected Regulatory Development – Investment Advisers – Reporting, Business Continuity and Performance Advertising

Brian S. Vargo, Partner, Pittsburgh

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INDUSTRY GROWTH

- The number of investment advisers registered under the Investment Advisers Act of 1940 has risen by 17% in the last two years.
- Collectively they manage $70 trillion in assets, an increase of more than $40 trillion over the last decade.
- In response, the SEC has recently increased by 20% the number of examiners that monitor investment advisers and investment companies.

FORM ADV / REPORTING

- The amount of information that the SEC requires registered advisers to provide continues to increase.
- The SEC amendments to Form ADV to require disclosure of additional information regarding separately managed accounts.
- The SEC did not clarify whether a fund of one would be considered a separately managed account for this purpose.
- The compliance date for these amendments is October 1, 2017.

FORM ADV / REPORTING

- At the same time, the SEC amended Part 1A of Form ADV to provide for more efficient umbrella registration of multiple private fund adviser entities that operate a single advisory business.
- A similar procedure had originally been endorsed by the SEC in a letter to the American Bar Association of January 19, 2012.

BUSINESS CONTINUITY / TRANSITION

- The SEC proposed the business continuity and transition plan rule under Section 206 of the Advisers Act, which is the antifraud provision.
- If the rule is adopted, a violation of the rule would presumably constitute fraud.
- Many industry participants have expressed concern about the proposal to adopt the rule under Section 206.

BUSINESS CONTINUITY / TRANSITION

- In June of this year the SEC proposed a new rule to require registered advisers to adopt and implement written business continuity and transition plans.
- Most advisers have already implemented business continuity plans as a matter of best practice, but if this rule is adopted each adviser will be required to adopt a plan that is based upon the particular risks associated with the adviser's operations.
- Moreover, advisers would be required to have a transition plan in place should the adviser be unable to provide advisory services to its clients.

PERFORMANCE ADVERTISING: BACK-TESTED AND THIRD PARTY PERFORMANCE

- *Raymond J. Lucia Companies, Inc. and Raymond J. Lucia, Sr.*, September 3, 2015
- *F-Squared Investments, Inc.*, December 22, 2014
- *Virtus Investment Advisers, Inc.*, Nov. 16, 2015
- *Investment Advisers Paying Penalties for Advertising False Performance Claims*, August 25, 2016

SEC Rules – Other Hot Topics

Derek N. Steingarten, Partner, New York

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SEC Liquidity Risk - Final Rule 22e-4

LIQUIDITY RISK MANAGEMENT PROGRAM (LRMP)

- Funds must establish a written LRMP- approved by Board, reviewed annually, to consider the following factors:
  - Investment strategy and liquidity of portfolio investments during both normal and reasonably foreseeable stressed conditions
    - Whether strategy is appropriate for open-end fund
    - Extent to which strategy involves a relatively concentrated portfolio or large positions in particular issuers
    - Use of borrowings for investment purposes and derivatives
  - Short-term and long-term cash flow projections during both normal and reasonably foreseeable stressed conditions
  - Holdings of cash and cash-equivalents, as well as borrowing arrangements and other funding sources
- Proposed vs Final Rule – proposed rule required periodic review; final rule requires at least annual review

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LIQUIDITY RISK DEFINITION

- "[T]he risk that a fund could not meet requests to redeem shares issued by the fund *without significant dilution of remaining investors' interests in the fund*"
- "Significant dilution" – used to clarify that slight NAV movements are not implicated, but shareholder dilution is the focus
  - Staff noted such dilution can occur at levels much lower than a "fire sale situation"
- Funds must classify liquidity of portfolio investments
- In-Kind ETFs are exempt
- Proposed vs Final Rule – proposed definition used term "*materially affecting the fund's NAV,*" rather than "*significant dilution of remaining investors' interests in the fund*"

LIQUIDITY CATEGORIES- FINAL RULE

- **Highly liquid investments** –
  - any investment reasonably expected to be ***convertible to cash*** in current market conditions ***in three business days*** (or less) without a significant change to its market value
- **Moderately liquid investments** –
  - any investment reasonably expected to be ***convertible to cash*** in current market conditions ***in more than three calendar days but in seven calendar days or less*** without a significant change to its market value
- **Less liquid investments** –
  - any investment reasonably expected to be ***sold or disposed of*** in current market conditions ***in seven calendar days or less*** without a significant change to its market value, but where the sale or disposition is reasonably expected to ***settle in more than seven calendar days***
- **Illiquid investments** –
  - any investment that ***may not reasonably be expected to be sold or disposed of*** in current market conditions ***in seven calendar days or less*** without a significant change in the market value of the investment
- Based on an analysis of market, trading and investment-specific considerations
- Liquidity classifications are to be based on *current market conditions*
- Funds may *classify* the liquidity of portfolio investments by *asset class*
- Classifications must be reviewed at least monthly, or more frequently

LIQUIDITY CLASSIFICATIONS- PROPOSED RULE

- Proposed rule had six, rather than four, categories
- Included a list of nine factors to consider, which was replaced by the analysis of market, trading and investment-specific factors
- Only permitted liquidity review by position, rather than asset class
- Required ongoing liquidity classifications review, rather than monthly

HIGHLY LIQUID INVESTMENT MINIMUM (HLIM)

- Fund must establish a HLIM
  - Funds investing primarily in highly liquid investments do not need an HLIM
  - Defined as in the liquidity categories above
  - "Highly liquid investments" are defined as any investment reasonably expected to be convertible to cash in current market conditions in three business days (or less) without a significant change to its market value
  - Based on standard settlement cycle of T+2
- HLIM must be determined based on an analysis of LRMP factors discussed above
- HLIM set based on normal market conditions and during stressed conditions reasonably foreseeable during the period until next review (e.g., one year)
- Proposed vs Final Rule –
  - Proposed rule changed from 3-day liquid assets minimum to HLIM
  - Proposed limits on acquiring non-highly liquid assets when below minimum relaxed in final rule

15% ILLIQUID INVESTMENTS MAXIMUM

- 15% illiquid investment maximum
  - Defined as in the liquidity categories above
  - "Illiquid investments" are defined as any investment that may not reasonably be expected to be sold or disposed of in current market conditions in seven calendar days or less without a significant change in the market value of the investment
- Applies to funds and In-Kind ETFs
- Proposed vs Final Rule –
  - Proposed rule required divesture of investments when above 15%
  - Final rule limits acquisition of illiquid investments when above 15% and replaces prior SEC guidance with rule

IN-KIND ETFs

- Defined as an ETF that meets redemptions through in-kind transfers of securities, positions, and assets other than a *de minimis* amount of cash, that publishes its portfolio holdings daily
- Must adopt a LRMP:
  - Must analyze liquidity under LRMP
  - Not required to classify assets in 4 categories
- Tailored LRMP requirements:
  - Liquidity risks and needs must be periodically assessed
  - Relationship between ETF's portfolio liquidity and pricing and spreads of trading, including efficiency of arbitrage function
  - Effect of composition of baskets on overall liquidity of ETF's portfolio
- Not required to have HLIM
- Subject to 15% illiquid maximum
- Proposed vs Final Rule –
  - Proposed rule did not include HLIM and classifications exemptions
  - Proposed rule did not include tailored LRMP requirements

BOARD APPROVAL AND DESIGNATION OF RESPONSIBILITIES- FINAL RULE

- A fund's board (including majority of independent trustees) must *approve*:
  - The written LRMP (including a majority of independent trustees)
  - The investment adviser or officer(s) responsible for administering the LRMP
- A fund's board must *review*:
  - At least annually, a written report of the LRMP's adequacy and effectiveness
  - Initial LRMP approval may be done by review of a summary of the LRMP
  - Material changes to the LRMP

BOARD APPROVAL (CONT.)

- A fund must report to the board:
  - When it falls below its highly liquid investment minimum:
    - At the next regular board meeting, if the below the minimum for less than 7 calendar days
    - Within 1 business day, if below the minimum for more than 7 calendar days
  - When it exceeds 15% illiquid holdings:
    - Within 1 business day
    - With an explanation of extent and causes, and how fund plans to bring illiquid level back to or below 15%

BOARD APPROVAL AND DESIGNATION OF RESPONSIBILITIES- PROPOSED VS. FINAL RULE

- Proposed Rule
  - A fund's board is required to approve the fund's HLIM
  - A fund's board is required to approve material changes to the LMRP
- Final Rule
  - A fund's board is not required to approve the fund's HLIM
    - Unless a fund attempts to change it when it is below its minimum
  - A fund's board is not required to approve material changes to LRMP

LIQUIDITY RISK FINAL RULE - KEY DATES

- Adopted October 13, 2016
- June 1, 2017
  - N-1A disclosure, including disclosure of redemption methods
- December 1, 2018
  - Adoption of written LRMP (in form approved by the Board); reporting under Forms N-PORT and N-CEN begin
- January 31, 2019
  - First Form N-PORT filing with liquidity information from period-ending 12/31/18

Questions?

Form N-PORT

CURRENT PORTFOLIO HOLDING DISCLOSURE REQUIREMENT

- Currently, a fund must file its complete schedule of investments four times each year:
  - As part of the fund's semiannual and annual shareholder reports
    - Filed on Form N-CSR within 10 days after delivery to shareholders, which is required within 60 days of period-end
  - After the end of the first and third fiscal quarters
    - Submitted as a public filing on Form N-Q within 60 days of period-end

PORTFOLIO HOLDING DISCLOSURE REQUIREMENT WITH NEW FORM N-PORT

- A fund will continue to file its complete schedule of investments twice each year with the semiannual and annual reports on Form N-CSR
- 30 days after the end of each month, a fund will be required to file a more detailed portfolio holdings report on Form N-PORT
  - Information on Form N-PORT (with certain exceptions) will be made publicly available 60 days after each fiscal quarter
- Form N-Q will be rescinded (1940 Act Rule 30b1-5 will be removed and reserved)

SEC RATIONALE FOR REQUIRING ADDITIONAL PORTFOLIO INFORMATION

- More frequent and timely portfolio information will assist the SEC's risk analysis and other oversight, policy formulation, disclosure review
  - E.g., portfolio data reported on Form N-MFP informed SEC money market fund reform
- Enable sophisticated institutional investors and third-parties that provide investor services to better analyze portfolio holdings (e.g., industry observers and academics)
  - Public availability of Form N-PORT information only quarterly, with a 60-day lag

FORM N-PORT COMPLIANCE DATES

- June 1, 2018, for fund complexes with net assets of $1 billion or more
- June 1, 2019, for fund complexes with net assets of less than $1 billion
  - Net assets measured as of the most recent fiscal year end
  - A fund's first reports on Form N-PORT, reflecting data as of June 30 of the applicable year must be filed no later than July 30 of that year

FORM N-PORT COVERED ENTITIES

- Per new 1940 Act Rule 30b1-9:
  - Registered open- and closed-end funds
    - But not money market funds or small business investment companies (SBICs)
  - ETFs organized as UITs

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CONTENT OF FORM N-PORT

- Same disclosures as required by Form N-Q with the following new reporting requirements:
  - Controlled foreign corporations (CFCs) and their underlying investments
  - Amounts of certain liabilities:
    - Borrowings attributable to debt
    - Payables for delayed delivery, when-delivered, firm commitments, standby commitments, and liquidation preference for the fund's outstanding preferred

CONTENT OF FORM N-PORT (CONT'D)

- Funds with at least 25% notional debt exposure
  - Portfolio-level quantitative risk metrics that measure sensitivity to changes in interest rates, credit spreads, and asset prices
- Liquidity
  - Liquidity classification of each investment
  - Aggregate percentage of the portfolio invested in each of the liquidity categories
  - The highly liquid investment minimum

CONTENT OF FORM N-PORT (CONT'D)

- Derivatives
  - Detailed information about the characteristics and terms of each contract
  - Monthly net realized gain (loss) and net change in unrealized appreciation (depreciation)
    - Also reported for investments other than derivatives

CONTENT OF FORM N-PORT (CONT'D)

- Pricing and fund flows
  - Currently reported on Form N-SAR, but SEC believes monthly reporting is more helpful
  - Fund can use net sales/redemptions from omnibus accounts
- Securities lending
  - Transactions and counterparty exposures
  - Aggregate principal amount and aggregate value of each type of non-cash collateral received for loaned securities that is not treated as a fund asset

CONTENT OF FORM N-PORT (CONT'D)

- Monthly total returns for each of the preceding three months
- Certain information (i.e., nonpublic items or related explanatory notes) will not be made public even if included in public filings:
  - "Miscellaneous securities"
    - Up to 5%, held for less than 1 year prior to date of related balance sheet, and not previously publicly identified
  - Country of risk and economic exposure
  - Liquidity classification for portfolio investments
  - Highly liquid investment minimum
  - Delta for individual options, warrants, and convertibles

CONTENT OF FORM N-PORT (CONT'D)

- A fund must report portfolio information on the same basis it uses to calculate NAV (i.e., T+1)
- A fund may use its own methodology and conventions of its service provider when responding to certain items on Form N-PORT
  - May require subjective judgments
  - Must be consistent with the way the fund reports internally and to current and prospective investors
    - Modeled after a similar instruction in Form P-F

FORM N-PORT FILING REQUIREMENTS, FORM N-CSR CERTIFICATIONS

- Filing — Electronically filed in a structured data format, extensible markup language (XML) on EDGAR
- Form N-CSR certification
  - Principal executive and financial officers must certify
    - The accuracy of information reported to the SEC, and
    - Disclosure controls and procedures and internal control over financial reporting during the most recent fiscal half-year
      - Currently, funds certify only as to the second quarter in the period covered by the report
  - Rescinds certifications required on Form N-Q

SEC’s Proposed New Limits on Derivative Use

SUMMARY OF PROPOSED RULE

- The SEC designed the rule to provide a "modernized, more comprehensible approach" to derivatives regulation
- The proposed rule would limit the way mutual funds, closed-end funds, and ETFs use derivatives and create risk management measures designed to protect investors
  - Portfolio limitations
  - Asset segregation
  - Risk management program
- The rule would replace the existing asset segregation regime developed over the last 35+ years

REQUIREMENTS FOR DERIVATIVES: PORTFOLIO LIMITATIONS FOR DERIVATIVES TRANSACTIONS

- A fund must comply with one of two portfolio limitations, designed to limit leverage the fund may obtain through derivatives and financial commitment transactions
  - *Exposure-based portfolio limit*
    - Aggregate exposure cannot exceed 150% of net assets
    - Exposure is the sum of the aggregate notional amount of derivative transactions, financial commitment transactions, and other senior security transactions
  - *Risk-based portfolio limit*
    - Aggregate exposure is limited to 300% of net assets *if* the fund can satisfy a risk-based test
    - The VaR-based test is intended to determine if the *aggregate* effect of derivatives transactions decreases the market risk of the fund's portfolio
  - The exposure limits are *in addition to* exposure from the fund's securities portfolio

REQUIREMENTS FOR DERIVATIVES: ASSET SEGREGATION FOR DERIVATIVES TRANSACTIONS

- A fund must segregate certain assets equal to the sum of two amounts:
  - *Mark-to-market coverage amount*. The amount the fund must pay to exit the derivative transaction
    - May be reduced by variation margin
  - *Risk-based coverage amount*. A reasonable estimate of what the fund would pay to exit the derivatives transaction under stressed conditions
    - Determined by the fund's board of directors
    - May be reduced by initial margin
- Only cash and cash equivalents may be used to meet the segregation requirement
- *Note:* Different rules apply for financial commitment transactions

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ASSET SEGREGATION: REQUIREMENTS FOR FINANCIAL COMMITMENT TRANSACTIONS

- A fund that enters into financial commitment transactions must segregate assets equal to the *full amount* of cash or other assets the fund is obligated to pay or deliver
- "Financial commitment transactions" include:
  - Reverse repurchase agreements
  - Short sale borrowing
  - Firm or standby commitment agreements (or similar agreements)
- Pledged collateral may be used as segregated assets

REQUIREMENTS FOR DERIVATIVES: DERIVATIVES RISK MANAGEMENT PROGRAM

- Funds that engage in complex derivatives transactions or that trade derivatives frequently (*i.e.*, notional exposure >50% of NAV) must develop a formalized derivatives risk management program
- The fund's board of directors must:
  - Review and approve the program
  - Receive quarterly risk reports
  - Appoint a derivatives risk manager
- This requirement is *in addition* to the broader risk management requirements that apply to all funds

DISCLOSURE AND REPORTING

- The proposed amendment would require each fund with a derivatives risk management program to disclose risk metrics related to its use of certain derivatives on proposed Form N-PORT
- The proposed amendment would require a fund to disclose identify the portfolio limitation(s) on which it relied (*i.e.*, exposure based or risk based) during the reporting period on proposed Form N-CEN

CHANGES FROM CURRENT REGULATORY SCHEME:

CURRENT SCHEME	PROPOSED SCHEME
▪ *Limits on leverage*. Permitted senior debt securities must meet 300% asset coverage ratio; no cap on leverage obtained through derivative positions if segregation obligations are met	Asset coverage requirements for senior debt securities remain – and – Absolute ceiling on leverage senior security-like transactions equal to 150% NAV, or 300% NAV if the fund satisfies the risk-based test
▪ *Derivatives risk manager*. No derivatives risk manager or risk management program	Must appoint derivatives risk manager if fund engages in frequent/complex derivatives transactions
▪ *Segregation of assets*. Must segregate any **liquid assets** sufficient to meet obligations equal to **mark-to-market exposure amount** (derivatives that net settle in cash) ***or* full notional amount** of obligation (derivatives that physically settle and CDS)	Must segregate cash or cash equivalents sufficient to meet obligations equal to: ▪ Mark-to-market exposure for derivatives ▪ Entire obligation for financial commitment transactions

COMMISSIONER PIWOWAR'S RECENT REMARKS

- At an October 12 conference at Georgetown University, SEC Commissioner Michael Piwowar said he did not foresee approval for the proposal in 2016, preferring to wait until after the elections
  - SEC Chair Mary Jo White originally identified finalizing the rule among her priorities for 2016, but the next U.S. President could replace White with a new chair
  - Questions remain as to how derivatives caps would affect leveraged funds and their abilities to hedge
  - Piwowar originally voted against releasing the proposal because the SEC had not yet gathered relevant data

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