

The logo for K&L GATES, featuring the text in white on an orange rectangular background.

K&L GATES

A blurred background image of a city skyline at night, with lights from buildings and streets creating a bokeh effect.

2016 INVESTMENT MANAGEMENT CONFERENCE

Transactions With Affiliates

Alan C. Porter

LEGISLATIVE POLICY

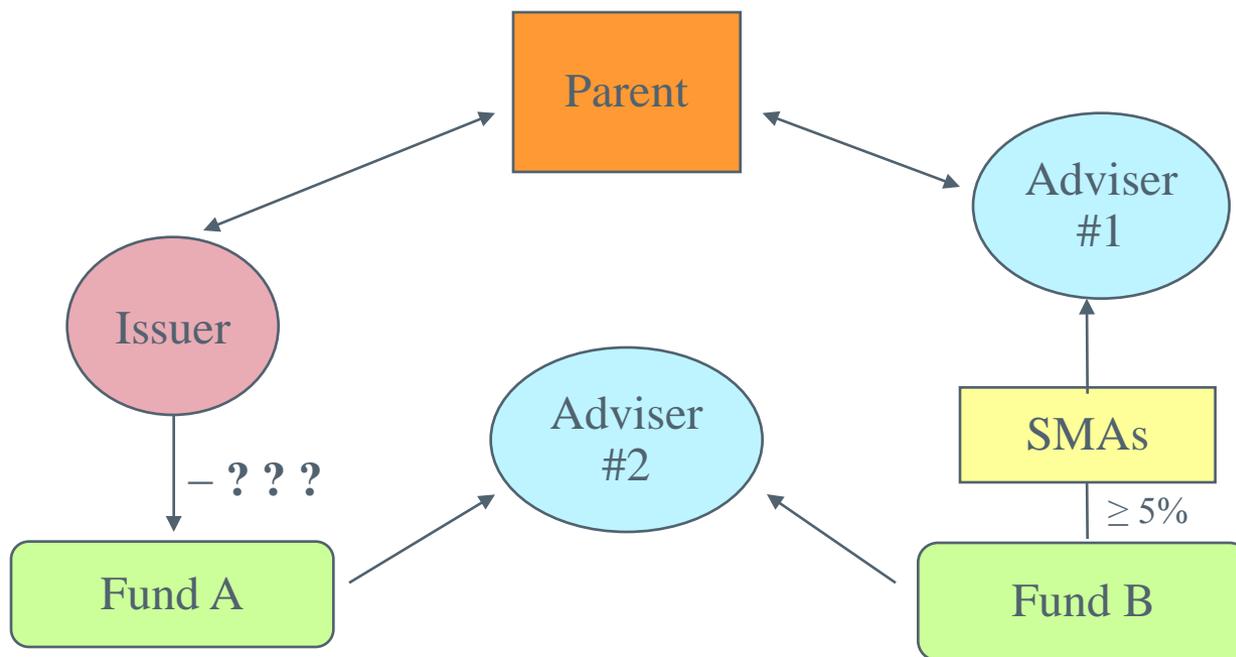
“In the exhaustive study of the industry which preceded passage of the [1940] Act it was found that, in many instances, investment companies had been operated in the interests of their managers rather than in the interests of their shareholders.”

“Congress determined that the [1933 and 1934 Acts] were inadequate to meet the problems which had been revealed . . . and passed a special regulatory statute – the Investment Company Act.”

*SEC Report on the Public Policy Implications
of Investment Company Growth (1966)*



IS THERE A PROHIBITED TRANSACTION?



AFFILIATED PERSON – SECTION 2(A)(3)

One-Way Affiliations

- Director
- Officer
- Partner
- Employee
- Investment Adviser

A director, officer, or investment adviser is an “affiliated person” of the fund; *but* the fund is not an “affiliated person” of its directors, officers, or investment adviser.

Two-Way Affiliations

- A person directly or indirectly controlling, controlled by, or under common control with, another person;
- A person directly or indirectly owning, controlling, or holding with power to vote, 5% or more of the outstanding voting securities of another person; and
- A person 5% or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person.

A 5% shareholder is an “affiliated person” of a fund; and the fund is an “affiliated person” of its 5% shareholder.

OWNERSHIP

Ownership is not defined in the 1940 Act. Ownership can include both legal ownership and beneficial ownership.

- 1934 Act Rule 13d-3 defines beneficial ownership based on
 - Voting power; and/or
 - Investment power
- 1934 Act Rule 16a-1 defines beneficial ownership based on
 - Direct or indirect pecuniary interest

CONTROL – SECTION 2(A)(9)

“[T]he power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of an official position with such company.”

- Control is presumed when a person directly or indirectly owns beneficially more than 25% of the outstanding voting securities of a company. (“Voting security” is defined in Section 2(a)(42).)
- The presumption of control is rebuttable.
- Natural persons are presumed not to be controlled.

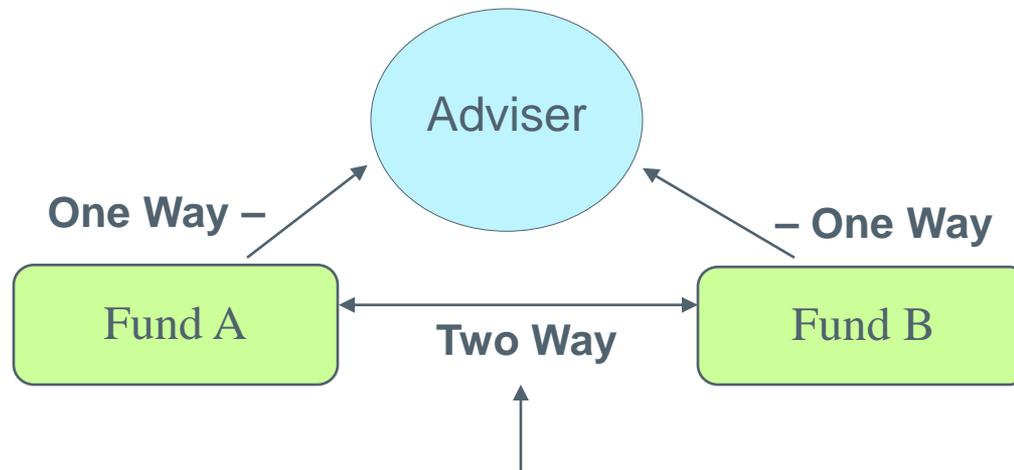
FUND COMPLEX AFFILIATIONS

“The nature of the advisory relationship has been considered to carry with it a strong indication of control. [However,] investment companies with a common investment adviser are not necessarily under common control.” Fundtrust, SEC No-Action Letter (May 26, 1987).

- Funds under common control may be deemed to be first-tier affiliates of one another.

FUND COMPLEX AFFILIATIONS

Neither Fund A nor Fund B is an affiliated person of Adviser. Thus, Fund A and Fund B are not second-tier affiliates (an affiliated person of an affiliated person).



But if Fund A and Fund B are under common control, then they are first-tier affiliates; and the affiliation is two-way — Fund A is an affiliated person of Fund B and vice versa.

CATEGORIES OF PROHIBITED TRANSACTIONS

- Principal Transactions
 - Section 17(a)
 - Section 17(d) and Rule 17d-1
- Agency Transactions
 - Section 17(e)
- Underwritings
 - Section 10(f)

SECTION 17(A)

- Section 17(a) prohibits first-tier and second-tier affiliates of a fund, acting as principal, from:
 - 1) Knowingly selling any securities or other property (except fund shares) to the fund;
 - 2) Knowingly purchasing any securities or other property (except fund shares) from the fund;
 - 3) Borrowing money or other property from the fund; or
 - 4) Loaning money or other property to the fund in contravention of SEC regulations.

SECTION 17(D) AND RULE 17D-1

Section 17(d) and Rule 17d-1 prohibit first-tier and second-tier affiliates of a fund, acting as principal, from engaging in a joint arrangement with the fund.

- Rule 17d-1(c) defines “joint arrangement” as:

“a written or oral plan, contract, authorization or arrangement, or any practice or understanding concerning an enterprise or undertaking whereby a [fund] and [a first-tier or second-tier affiliate] have a joint or a joint and several participation, or share in the profits”

SECTION 17(E)

- Section 17(e) prohibits first-tier and second-tier affiliates of a fund:
 - 1) Acting as agent, from accepting any compensation for the purchase or sale of any property to or from the fund (except in the course of its business as an underwriter or broker); or
 - 2) Acting as broker, from receiving a commission, fee, or other remuneration for effecting a securities transaction for the fund which exceeds:
 - A. the “usual and customary broker’s commission” if the sale is effected on a securities exchange; or
 - B. 2% of the sale price in a secondary distribution; or
 - C. 1% of the sale price for other transactions.

SECTION 10(F)

Section 10(f) prohibits a registered investment company from knowingly purchasing securities underwritten by a fund

- Officer
- Director
- Advisory Board Member
- Investment Adviser
- Employee, or
- First-tier Affiliate of any of the above

STATUTORY EXEMPTIONS

Section 17(b)

The SEC may, upon application by any person, issue an order permitting a prohibited principal transaction.

The SEC must find that the transaction is:

- Reasonable and fair and does not involve overreaching on the part of any person concerned; and
- Consistent with the policy of each fund concerned and with the general purposes of the Investment Company Act.

Section 6(c)

The SEC may, upon application, conditionally or unconditionally exempt any person, security or transaction, or any class of persons, securities or transactions, from any provision of or rule under the Investment Company Act. The SEC must find that the requested exemption is:

- 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 Investment Company Act.

SELECTED EXEMPTIVE RULES

- Rule 17a-7 – Portfolio Cross Transactions
- Rule 17a-8 – Fund Reorganizations
- Rule 17a-9 – Purchase of MMF Portfolio Securities
- Rule 17d-1(c) – Certain Joint Arrangements
- Rule 17e-1 – Transactions with Affiliated Brokers

PORTFOLIO CROSS TRANSACTIONS

Rule 17a-7 permits purchase or sale transactions between:

- Affiliated funds; and
- Fund and non-fund accounts affiliated solely by reason of having a common adviser.

CONDITIONS

- The transaction must be a purchase or sale, for no consideration other than cash payment against prompt delivery of a security for which market quotations are readily available.
- The transaction must be effected at the independent “current market price” of the security.
- The transaction must be consistent with the policies of each participating fund.
- No brokerage commission, fee (except customary transfer fees) or other remuneration may be paid in connection with the transaction.

The “current market price” of a security is:

- For securities whose principal market is an exchange:
 - the last sale price on the exchange or,
 - if there are no reported transactions that day, the average of the highest current independent bid and lowest current independent offer on the exchange.
- For other securities:
 - the average of the highest current independent bid and lowest current independent offer determined on the basis of reasonable inquiry.

ADDITIONAL CONDITIONS

- The fund board (including a majority of the independent directors) must:
 - Adopt procedures which are reasonably designed to provide that all conditions of the rule will be met; and
 - Determine at least quarterly that all transactions during the preceding quarter were in compliance.
- The fund board must satisfy the governance standards defined in Rule 0-1(a)(7).

FUND REORGANIZATIONS

Rule 17a-8 permits reorganization transactions between:

- Affiliated funds;
- A fund and an affiliated common or collective trust;
and
- A fund and an affiliated insurance company separate account.

CONDITIONS

- The fund board (including a majority of the independent directors) must determine that:
 - Participation in the transaction is in the best interests of the fund; and
 - The interests of the fund's existing shareholders will not be diluted as a result of the transaction.
- The board must request and evaluate information necessary to make these determinations and give appropriate weight to all pertinent factors.
- The board's determinations and the bases for them must be recorded fully in the fund's minute book.

ADDITIONAL CONDITION

- Approval by an acquired fund's shareholders is required, unless:
 - The fundamental policies of the surviving fund are not materially different;
 - The advisory contact of the surviving fund is not materially different;
 - The independent directors elected by acquired fund shareholders will comprise a majority of the independent directors of the surviving fund; and
 - The 12b-1 fees paid by the surviving fund are not greater than those authorized by the acquired fund.

PURCHASE OF MMF PORTFOLIO SECURITIES

Rule 17a-9 permits a first-tier or second-tier affiliate to purchase a portfolio security from a money market fund if:

- The purchase price is paid in cash;
- The purchase price is equal to the greater of the amortized cost value of the security or its market price; and
- Any profit on a subsequent sale of certain securities is paid to the fund.

CERTAIN JOINT ARRANGEMENTS

Rule 17d-1(d)(c) provides an exemption for certain joint arrangements, including:

- Joint liability insurance policies, provided:
 - Participation is in the fund's best interests;
 - Premiums are allocated in a fair and reasonable manner; and
 - The policy does not exclude coverage for claims made against an independent director by another insured.
- Assumption by an adviser of expenses incurred in connection with a fund reorganization.

AFFILIATED BROKERAGE

Rule 17e-1 provides a “safe harbor” from the restriction of Section 17(e)(2)(A), which prohibits a broker from receiving remuneration from an affiliated fund in excess of the “usual and customary” broker's commission.

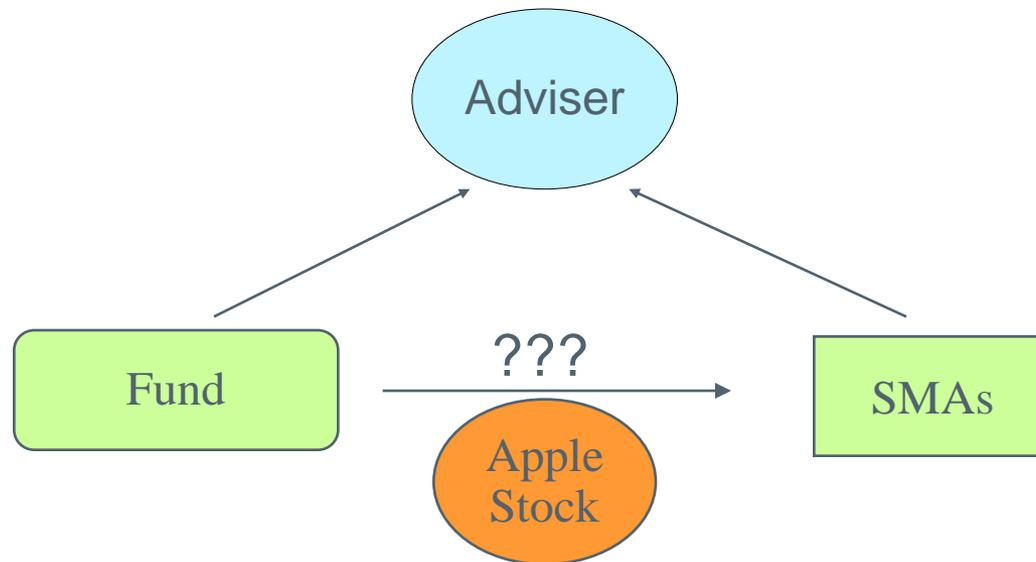
A commission, fee, or other remuneration is deemed as not exceeding the usual and customary broker's commission if the conditions of the rule are met.

RULE 17E-1 CONDITIONS

- Commissions paid by the fund must be reasonable and fair in comparison to what others charge for comparable transactions.
- The fund board (including a majority of the independent directors) must:
 - Adopt procedures which are reasonably designed to provide that the commissions paid by the fund meet this standard; and
 - Determine at least quarterly that transactions during the preceding quarter were in compliance.
- The fund board must satisfy the governance standards defined in Rule 0-1(a)(7).

PORTFOLIO CROSS TRANSACTION

Fund's portfolio manager has decided to sell Apple stock; the portfolio manager of Adviser's separately managed accounts (SMAs) has decided to purchase Apple stock.

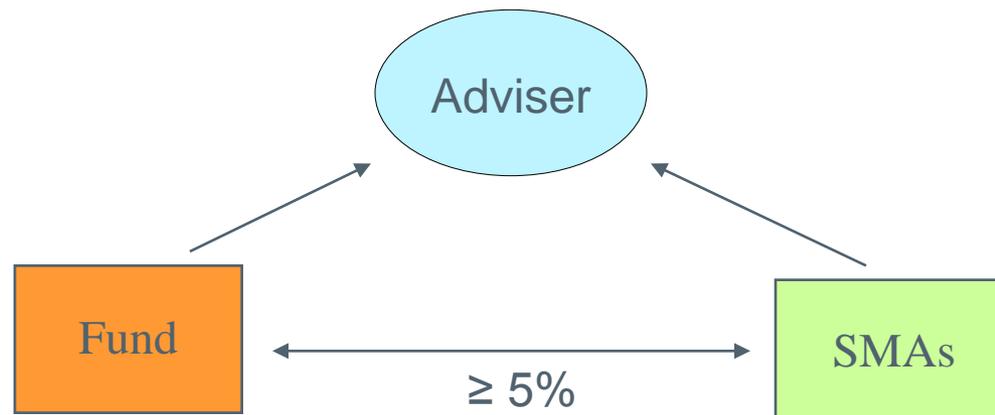


Does Section 17(a) prohibit a cross transaction between Fund and SMAs?

Yes, but . . .

Rule 17a-7 provides an exemption for this transaction if Fund and SMAs are first-tier or second-tier affiliates solely by reason of having a common investment adviser or investment advisers which are affiliated persons of each other, common directors, and/or common officers.

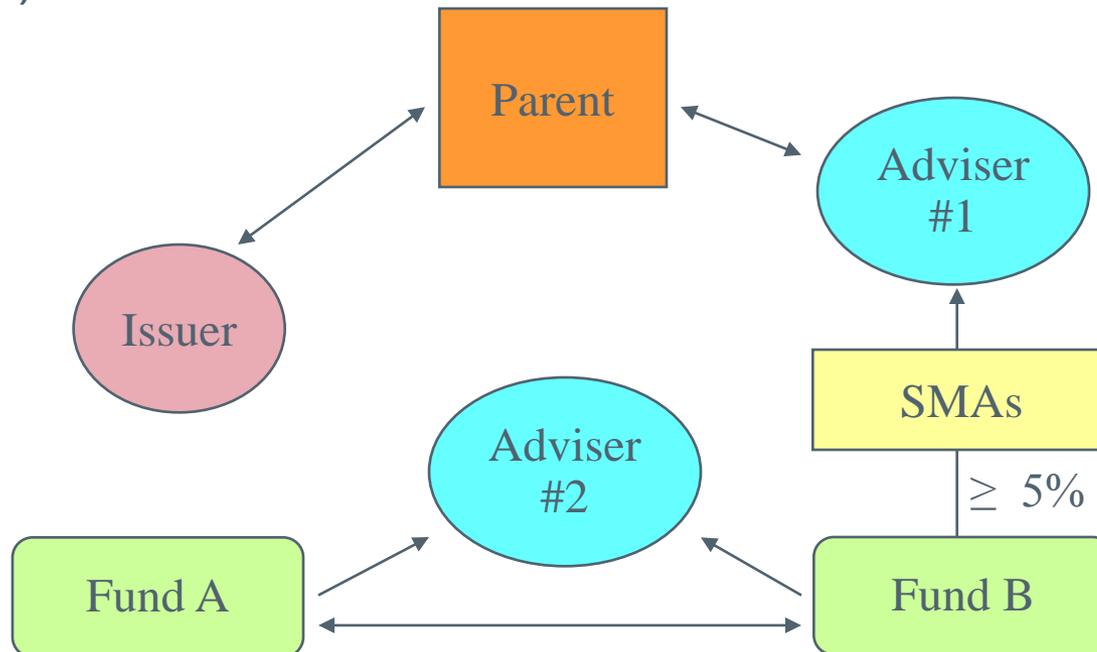
What if the SMAs hold 5% or more of Fund's shares?



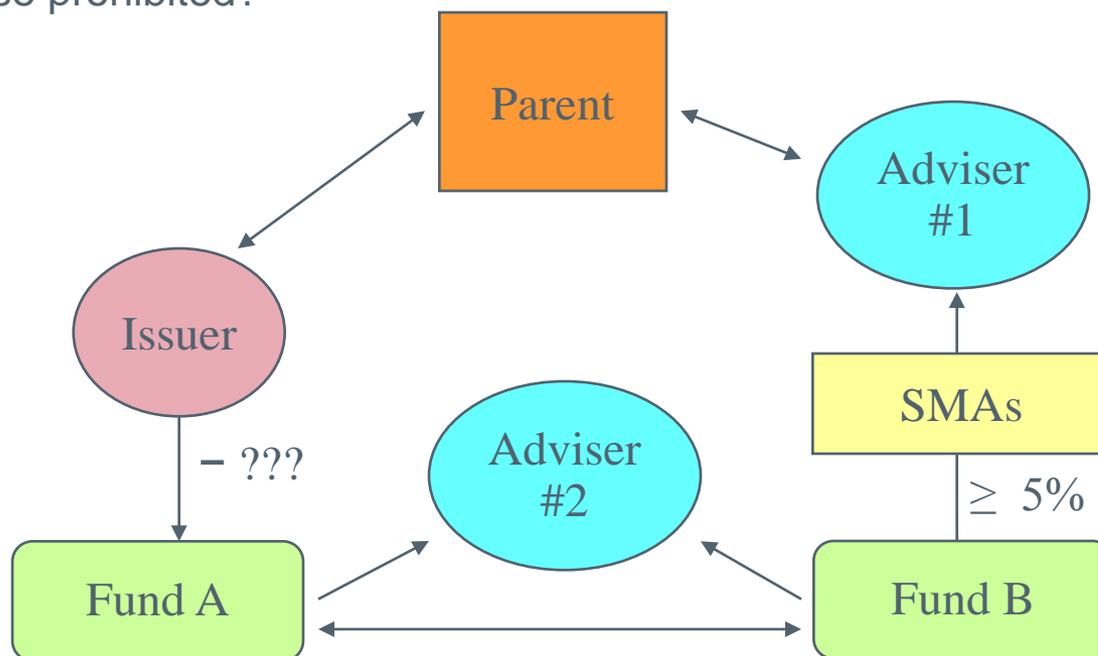
Then, Rule 17a-7 would not be available because Fund and the SMAs would not be affiliated solely by reason of having a common adviser.

TRANSACTION WITH UPSTREAM AFFILIATE

- Fund A's portfolio manager wants to buy securities issued by a subsidiary of Parent (Issuer). SMAs over which another subsidiary of Parent (Adviser #1) has investment discretion hold 5% or more of Fund B (another fund in Fund A's fund complex).



Is the purchase prohibited?



Fund A and Fund B are first-tier affiliates (deemed to be under common control).
 Adviser #1 is Fund B's first-tier affiliate (5% owner) and Fund A's second-tier affiliate.
 SEC may collapse the holding company structure (Issuer = Adviser #1).
 Section 17(a)(1) prohibits Issuer from knowingly selling securities to Fund A (its second-tier affiliate) in a principal transaction.

TAKEAWAYS

- Be alert for potential affiliated transaction issues; violations can result in significant liability for a fund affiliate.
- Diagram the relationships for analysis.
- Talk it through with a knowledgeable colleague.
- Follow fund compliance procedures when effecting transactions pursuant to an exemptive rule.



Questions?



K&L GATES