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Registered Funds

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Exchange-Traded Funds (ETFs)

Peter J. Shea, Partner, New York

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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*

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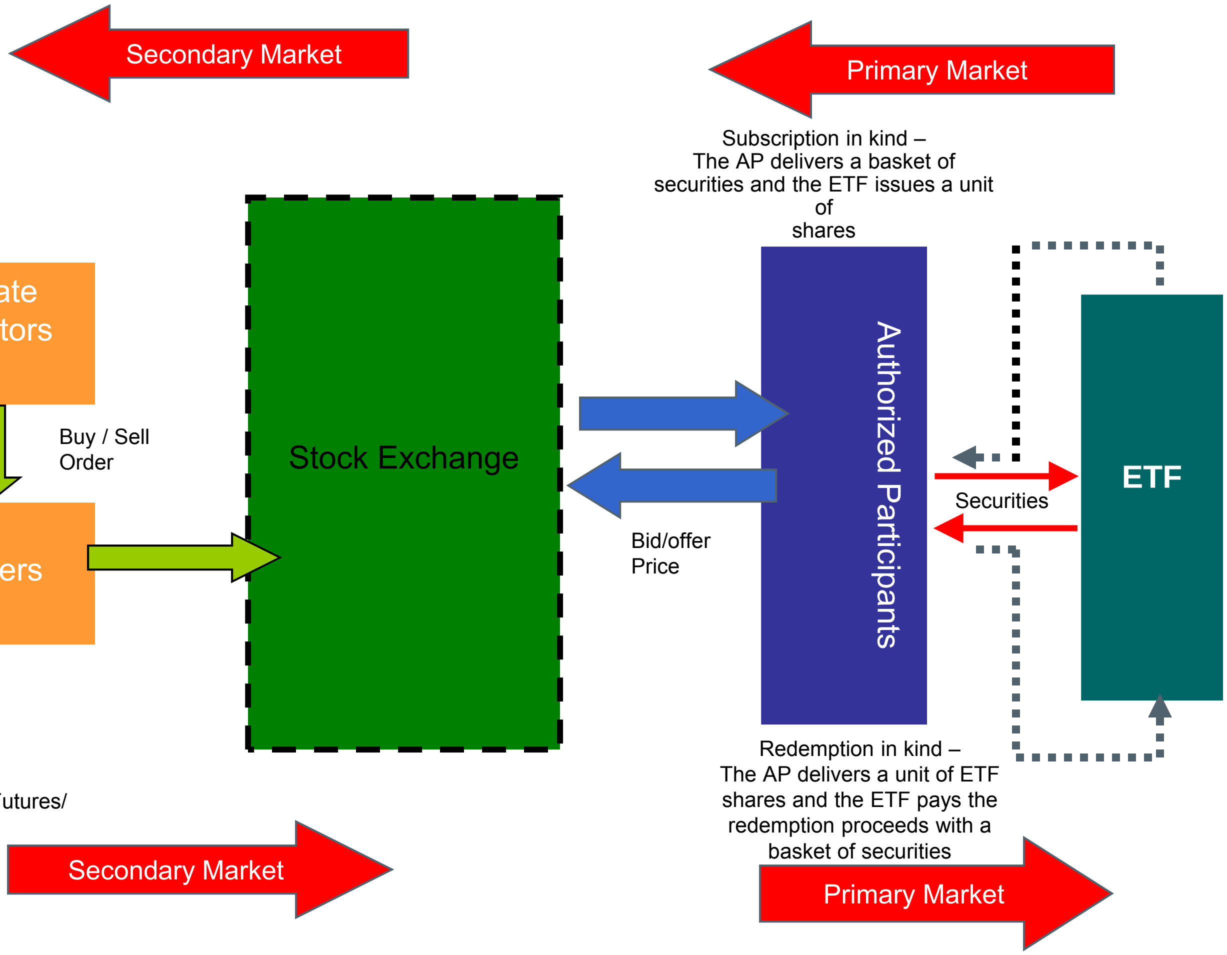
HOW DO ETFS WORK?



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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"

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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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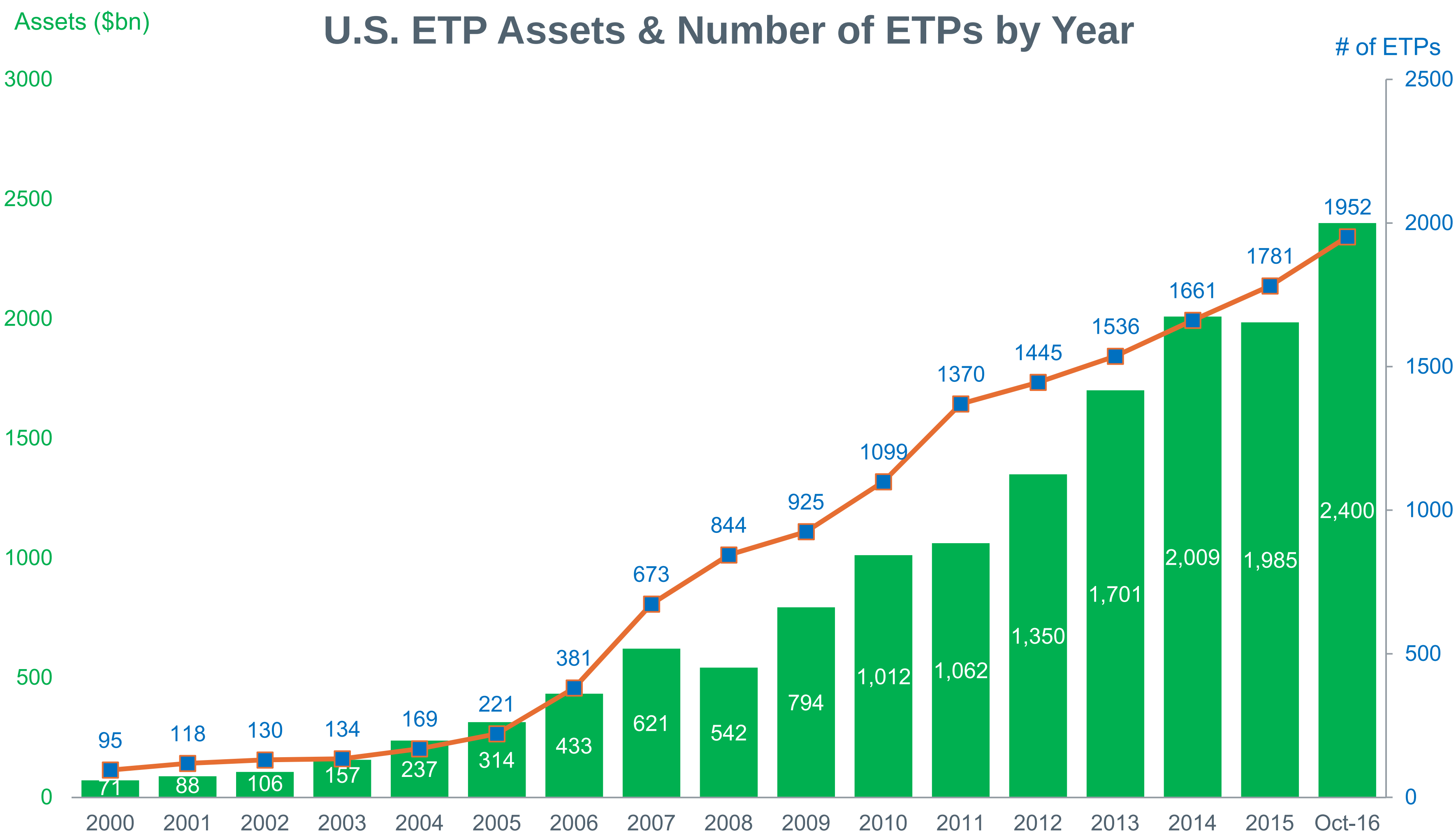
LIQUIDITY RULE - IMPACT ON ETFs

- 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 <u>with carveouts</u>
    - <u>No requirement</u> to assign investments to 1 of 4 “days-to-cash” buckets
    - <u>No requirement</u> of highly liquid investment minimum
  - Must report designation as an In-Kind ETF on Form N-CEN

BUSINESS CONSIDERATIONS



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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

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]"

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

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SEC Rules – Other Hot Topics

Derek N. Steingarten, Partner, New York

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

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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

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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?

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

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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

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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

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

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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

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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

CURRENT STATUS OF DERIVATIVES RULE

- Former SEC Chair Mary Jo White had identified a goal of finalizing the rule in 2016, but comments from SEC Commissioner Piwowar in October made it clear that further action on the Derivatives Rule would be postponed.

- In early November the SEC released additional data and analysis responding to industry comments regarding the manner in which derivatives exposure should be measured and the concept of permitting a greater variety of qualifying coverage assets (in addition to cash), subject to "haircuts".

- With a dramatically different approach to regulation under the Trump administration, Jay Clayton as the new SEC Chair and upcoming appointments to the Commission it seems likely that changes will be made to the rule prior to adoption (if it is adopted).

- Areas of focus include how the hard caps on derivatives use would affect leveraged funds and the ability of some funds to hedge appropriately (including income-oriented funds active in the bond market).

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Update on Section 36(b) Litigation

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Section 36(b) Litigation Overview

- Over 20 cases now pending
- Plaintiffs continue to meet with a lack of success
- Yet new cases continue to be filed
- And new plaintiffs' law firms are appearing

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The Recent Wave of Section 36(b) Cases

- Manager-of-managers cases
  - Adviser/manager contracts with fund
  - Adviser subcontracts portfolio management services
- Subadviser cases
  - Manager contracts to subadvise other funds
  - Fees as subadviser are lower
- Fund-of-fund cases
  - Adviser receives fees from underlying fund
  - Adviser receives "Acquired Fund Fees"
  - Adviser acts as manager-of-managers

Manager-of-Manager Cases

- AXA (D.N.J)
- Hartford (D.N.J)
- ING/Voya (D. Del.)
- Russell (D. Mass.)
- SEI (E.D. Pa.) (recently dismissed by stipulation)
- Harbor (N.D. Ill.)
- New York Life (D.N.J)
- Prudential (D. Md.)
- State Farm (C.D. Ill.)
- Principal (S.D. Iowa)
- Great-West (D. Col.)

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Subadviser Cases

- BlackRock (D.N.J.)
- JP Morgan (S.D. Ohio)
- Davis (S.D.N.Y.)
- First Eagle (D. Del.)
- Calamos (S.D.N.Y.)
- Met West (C.D. Cal.)
- T. Rowe Price (N.D. Cal.)
- Harris Associates (Oakmark Funds) (N.D. Ill.) (recently dismissed by stipulation)

Other More “Traditional” Section 36(b) Cases

- PIMCO (W.D. Wash.)
- Fiduciary Management (E.D. Wisc.) (recently dismissed by stipulation)
- Prospect Capital (S.D.N.Y.)

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Section 36(b) Scorecard

- Plaintiffs usually prevail on motions to dismiss
- Of three recent motions for summary judgment, one was denied and two were granted in part and denied in part
- Two cases have recently gone to trial
  - Defendants prevailed in first trial (AXA)
  - Second trial recently concluded (Hartford)
  - Others anticipated in 2017
- Few settlements

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The Gartenberg Standard

- *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*
  - To violate Section 36(b), "the adviser-manager must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining"
  - "[T]he test is essentially whether the fee schedule represents a charge within the range of what would have been negotiated at arm's length in the light of all of the surrounding circumstances"
- Adopted by the Supreme Court, with some modifications, in *Jones v. Harris Associates LP*

Gartenberg Factors

- Consideration of "all facts in connection with the determination and receipt of such compensation," including:
  - The nature and quality of services rendered
  - The profitability of the fund to the investment adviser
  - Economies of scale
  - Comparative fee structures
  - Fall-out benefits
  - The independence of the unaffiliated directors and the care and conscientiousness with which they performed their duties

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Plaintiffs' Typical Contentions

- Nature of the services
  - You don't do very much
  - What you do is largely duplicative
  - What you do is the board's responsibility

Plaintiffs' Typical Contentions, cont'd

- Quality of the services
  - Services are not very good
    - Generally short-term performance
  - Even if the services are good, you are not responsible for that
  - It really doesn't matter
    - Multi-fund cases have mixed performers
    - Single-fund cases have average performers

Plaintiffs’ Typical Contentions, cont’d

- Conventional Profitability analysis
  - Total advisory fee = 100
  - Total adviser costs = 60 (30 to subadviser)
  - Profit = $\frac{100 - 60}{100}$ = 40%

Plaintiffs’ Typical Contentions, cont’d

- Profitability plaintiff style – one version
- Total advisory fee = 100
- Subadviser’s share of fee = 30
- Adviser’s “retained” fee = 70
- Adviser’s costs = 30
- “Net Profit” = $\frac{70 - 30}{70} = \frac{40}{70} = 57.1\%$

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Plaintiffs' Typical Contentions, cont'd

- Profitability plaintiff style – another version
  - Plaintiffs challenge expense allocations — including allocation of costs from outside the adviser
    - Total fee = 100
    - Subadviser fee = 30
    - Adviser's "retained" fee = 70
    - Adviser's costs = 10
- "Net Profit" $= \dfrac{70 - 10}{70} = \dfrac{60}{70} = 85.7\%$

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Plaintiffs' Typical Contentions, cont'd

- Economies of Scale
  - Core staff and infrastructure constant as fund grows
  - The same staff and infrastructure manage multiple funds
  - The dollar numbers get very large
  - Any breakpoints provide trivial benefits

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Plaintiffs' Typical Contentions, cont'd

- Comparative fee structures
  - Comparison of adviser fee to subadviser fee
  - What do you do for your portion?
  - "Admission" of value of services at arm's length

Plaintiffs' Typical Contentions, cont'd

- Conscientiousness of directors/trustees
  - "House directors"
  - Oversight of multiple funds
  - "Conflicted counsel"
  - Procedural flaws
  - Papering the record
  - Lack of understanding of issues

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AXA Trial

- First Section 36(b) trial since 2009
- Twenty-five days
- Lengthy opinion (159 pages)
- Case now on appeal
- Credibility determinations key
- Failure to meet burden of proof

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AXA Opinion – Board Process

- Extraordinarily detailed review of evidence
- Board "robustly reviewed" adviser compensation
- Effect of credibility determinations

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AXA Opinion – Adviser Services

- Court looked beyond contract terms to assess nature and quality of services
- Funds performed at or above expectations

AXA Opinion – Profitability

- Subadvisory fees are an “expense” not “contra revenue”
- Allocation of costs based on revenue was acceptable

AXA Opinion – Comparative Fees

- Reliance on Lipper appropriate
- Board aware of potential shortcomings

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Kasilag v. Hartford

- Three separate actions against Hartford filed in 2011, 2014, 2015 involving eight funds in total
- Cross-motions for summary judgment
- Scope of consolidated trial limited by April 2016 summary judgment ruling
  - Board approval of fees accorded "substantial weight" notwithstanding plaintiffs' "armchair quarterbacking and captious nitpicking" of the Board's process and the information it considered
  - Remaining Gartenberg factors still in play

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Kasilag v. Hartford, cont'd

- Four trial days in November 2016
  - Four expert witnesses; one Hartford representative
  - Focus on services, profitability, and fee competition
- Closing arguments upcoming

In Re Russell Investment Company Shareholder Litigation

- Complaint filed in October 2013 in the District of Massachusetts
- Background:
  - Fees paid by 10 mutual funds at issue
  - Complaint challenges advisory and administrative fees

Russell Motion For Summary Judgment

- Motion filed on June 24, 2016
- Familiar Arguments:
  - Subadvisory cases present unique issues, rendering prior case law distinguishable
  - Profitability:
    - Court should consider only the “Retained Fee”

Russell Motion For Summary Judgment, cont'd

- Board Deference
  - Court should apply sliding scale, not binary approach
  - Board failed to get the best possible deal
  - Board did not consider replacing the adviser/administrator
  - Board lacked information

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Russell Motion For Summary Judgment

- Hearing on November 15, 2016: Order on MSJ issued from the bench
  - Denies summary judgment as to fall-out benefits, profitability and quality of service
  - Grants summary judgment “as to all other claims”
- Trial scheduled for March 6, 2017

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Attack On The Attorney-Client Privilege: Kenny v. PIMCO

- Otherwise privileged Independent Trustee materials ordered produced to plaintiff shareholder
- Decision rooted in common law “fiduciary exception” applicable to ordinary trusts
- Potentially far-reaching implications if followed by other courts

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QUESTIONS?

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