

The background of the slide features a stylized financial chart with teal bars and a red line graph. Below the chart, there are horizontal bands of glowing blue light and binary code (0s and 1s) in a teal color. The K&L Gates logo is positioned in the top left corner.

K&L GATES

2017 WASHINGTON D.C. INVESTMENT MANAGEMENT
CONFERENCE

Transactions With Affiliates

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LEGISLATIVE POLICY

“In the exhaustive study of the industry which preceded passage of the [Investment Company] 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)*

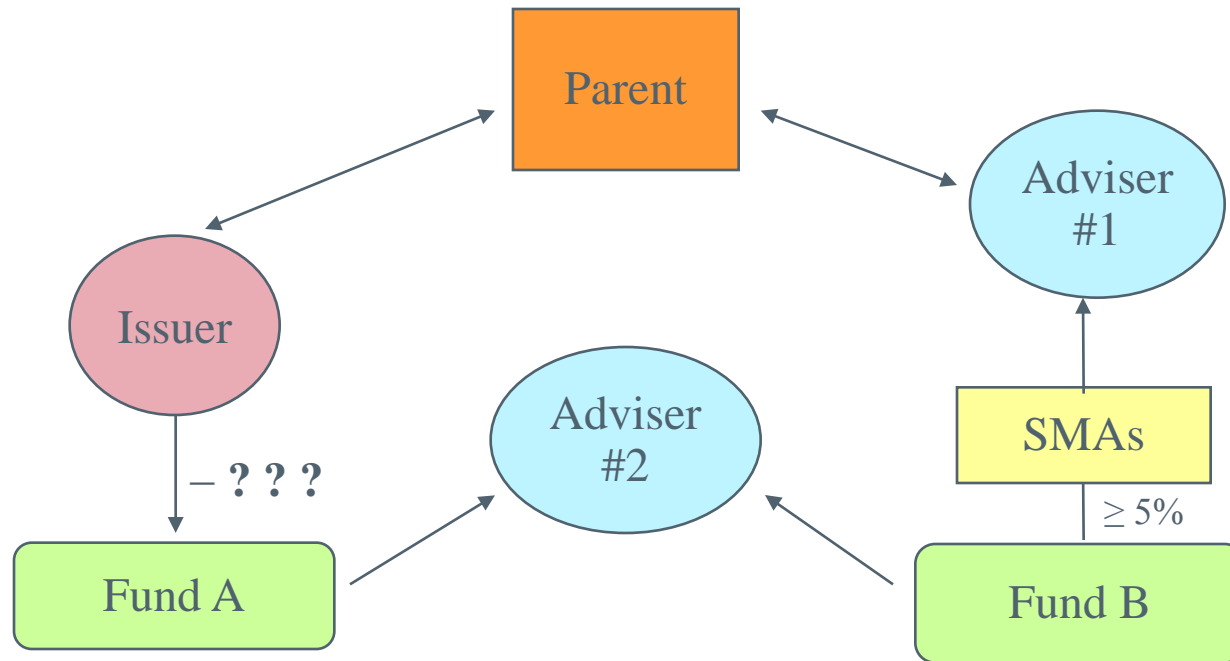


VALIDITY OF CONTRACTS – Section 47(b)(1)

“A contract that is made, or whose performance involves, a violation of [the Investment Company Act], or of any rule, regulation, or order thereunder, is unenforceable . . . unless a court finds that under the circumstances enforcement would produce a more equitable result . . . and would not be inconsistent with the purposes of [the Investment Company Act].”



IS THERE A PROHIBITED TRANSACTION?



AFFILIATED PERSON – Section 2(a)(3)

One-Way Affiliations

- Director
- Officer
- Partner
- Employee
- Investment adviser (including a sub-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.



AFFILIATED PERSON – Section 2(a)(3) (CONTINUED)

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 Investment Company Act; both legal and beneficial ownership can apply.

- Exchange Act Rule 13d-3 defines “*beneficial owner*” based on:
 - Voting power; and/or
 - Investment power
- Exchange Act Rule 16a-1 defines “*beneficial owner*” 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) as any security presently entitled to vote for the election of directors.
- The presumption of control is rebuttable.
- Natural persons are presumed not to be controlled.



FUND COMPLEX AFFILIATIONS

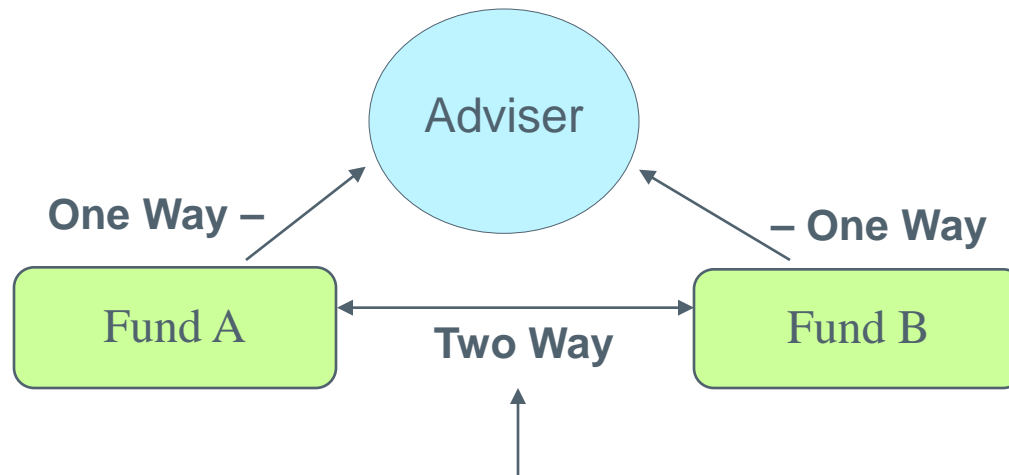
*“Investment companies with a common investment adviser are not necessarily under ‘common control’ and, therefore, are not necessarily affiliated persons solely for this reason. However, the nature of the advisory relationship has been considered to carry with it a strong indication of control.” FundTrust, SEC No-Action Letter (May 26, 1987) (citing *In re Steadman Security Corp.*, 46 S.E.C. 896 (1977)).*

- The determination whether investment companies with the same investment adviser are affiliated depends in each case on the particular facts and circumstances presented.
- 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 of one another).



But if Fund A and Fund B are under “*common control*,” 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)



PRINCIPAL TRANSACTIONS

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) Lending money or other property to the fund in contravention of SEC regulations.



PRINCIPAL TRANSACTIONS (CONTINUED)

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 such joint arrangements as:

“any written or oral plan, contract, authorization or arrangement, or any practice or understanding concerning an enterprise or undertaking whereby a [fund] and [its first-tier or second-tier affiliate] have a joint or a joint and several participation, or share in the profits of such enterprise or undertaking . . . , but shall not include an investment advisory contract subject to Section 15 of the [Investment Company] Act.”



AGENCY TRANSACTIONS

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.

UNDERWRITINGS

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

- Officer
- Director
- Advisory board member
- Investment adviser (or sub-adviser)
- Employee, or
- First-tier affiliate of any of the above



SEC EXEMPTIVE AUTHORITY

Section 17(b) provides that 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.



SEC EXEMPTIVE AUTHORITY *(CONTINUED)*

Section 6(c) provides that the SEC, by rules or regulations, or by order upon its own motion, or by application, may conditionally or unconditionally exempt any person, security or transaction, or any class of persons, securities or transactions, from any or all provisions of the Investment Company Act. The SEC must find that the 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.



SELECT EXEMPTIVE RULES

- Rule 17a-7 – Portfolio Cross Transactions
- Rule 17a-8 – Fund Reorganizations
- Rule 17a-9 – Purchases of Portfolio Securities from a Money Market Fund
- Rule 17d-1(c) – Certain Joint Arrangements
- Rule 17e-1 – Affiliated Brokerage Transactions



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 investment adviser.



RULE 17a-7 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.



RULE 17a-7 CONDITIONS *(CONTINUED)*

- The fund board (including a majority of the independent directors) must:
 - Adopt procedures which are reasonably designed to provide that all of Rule 17a-7's conditions will be complied with; and
 - Determine at least quarterly that all transactions during the preceding quarter were effected in compliance with such procedures.
- The fund board must satisfy the “*fund governance standards*” defined in Rule 0-1(a)(7).



FUND REORGANIZATIONS

Rule 17a-8 permits reorganization transactions between:

- Affiliated investment companies (or series);
- A fund and an affiliated common or collective trust fund; and
- A fund and an affiliated insurance company separate account.



RULE 17a-8 CONDITIONS

- The fund board (including a majority of the independent directors) must determine as to each participating fund 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 directors must request and evaluate such information as may be reasonably necessary to make their determinations, and give appropriate weight to all pertinent factors.
- The determinations and the bases thereof, including factors considered, must be fully recorded in the fund's minute book.



RULE 17a-8 CONDITIONS *(CONTINUED)*

- 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;
 - A majority of the surviving fund's independent directors will be comprised of independent directors elected by the acquired fund's shareholders; and
 - 12b-1 fees authorized to be paid by the surviving fund are no greater than those authorized to be paid by the acquired fund.



MONEY MARKET FUNDS

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

- The purchase price is paid in cash;
- The purchase price is equal to the greater of the amortized cost of the security or its market price; and
- For a security other than an “*eligible security*” or which has defaulted, any amount in excess of the purchase price received on any subsequent sale is paid to the fund.



CERTAIN JOINT ARRANGEMENTS

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

- Joint liability insurance policies, provided:
 - Participation is in the fund's best interests;
 - The proposed premium to be allocated to the fund is fair and reasonable to the fund; and
 - The policy does not exclude coverage for bona fide claims made against the independent directors, or the fund, by another insured under the policy.
- Payment of fund reorganization expenses by the fund's investment adviser.



AFFILIATED BROKERAGE

Rule 17e-1 provides a “safe harbor” from the restriction of Section 17(e)(2)(A), which prohibits an affiliated broker from receiving remuneration 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.



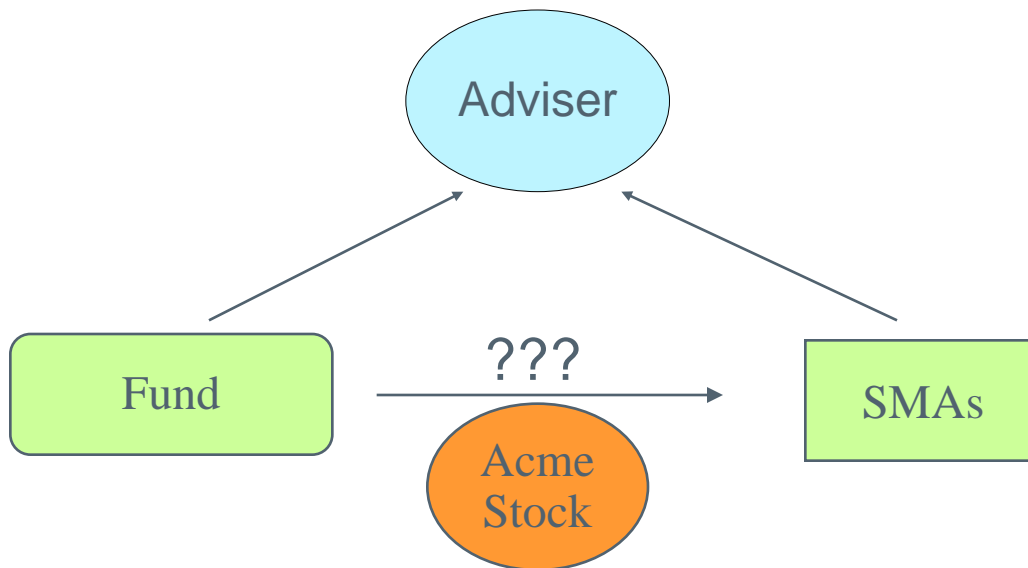
RULE 17e-1 CONDITIONS

- Commissions paid by the fund must be reasonable and fair in comparison to what other brokers receive in connection with comparable transactions.
- The fund board (including a majority of the independent directors) must:
 - Adopt procedures which are reasonably designed to provide that commissions paid to an affiliated broker are consistent with the standard above; and
 - Determine at least quarterly that all transactions during the preceding quarter were in compliance with the procedures.
- The fund board must satisfy the “*fund governance standards*” defined in Rule 0-1(a)(7).



PORTFOLIO CROSS TRANSACTION

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



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

PORTFOLIO CROSS TRANSACTION *(CONTINUED)*

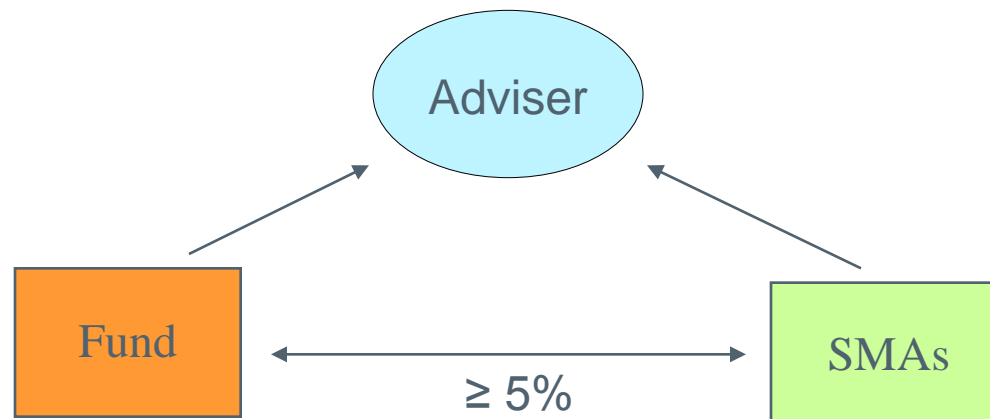
Yes, but . . .

Rule 17a-7 provides an exemption for this transaction if the Fund and the SMAs are 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.



PORTFOLIO CROSS TRANSACTION *(CONTINUED)*

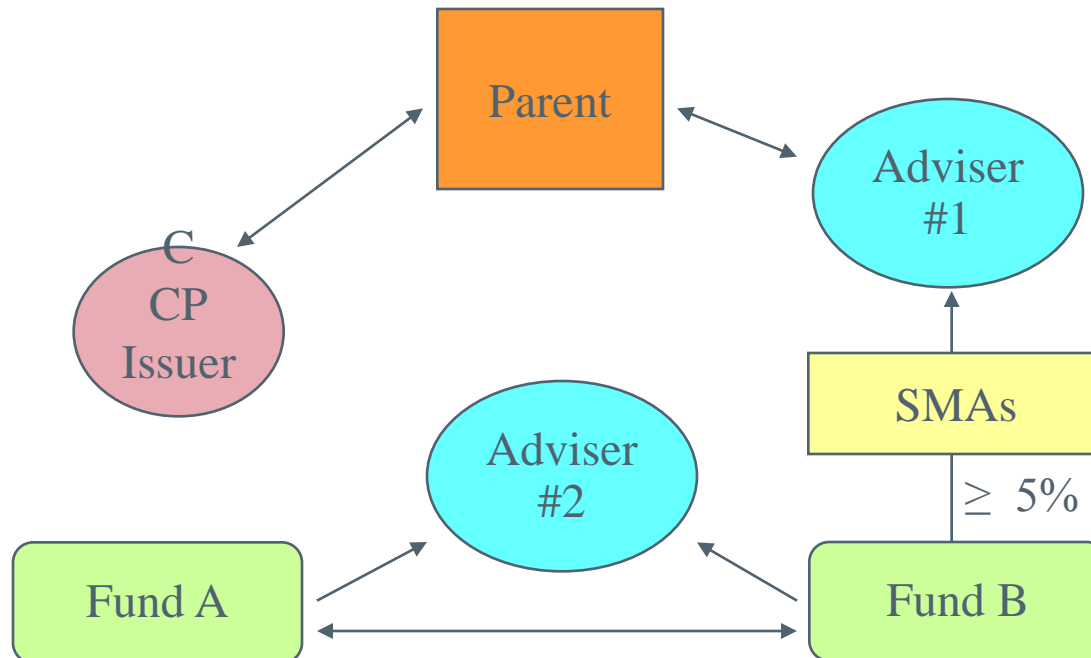
What if the SMAs hold 5% or more of the Fund's shares?



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

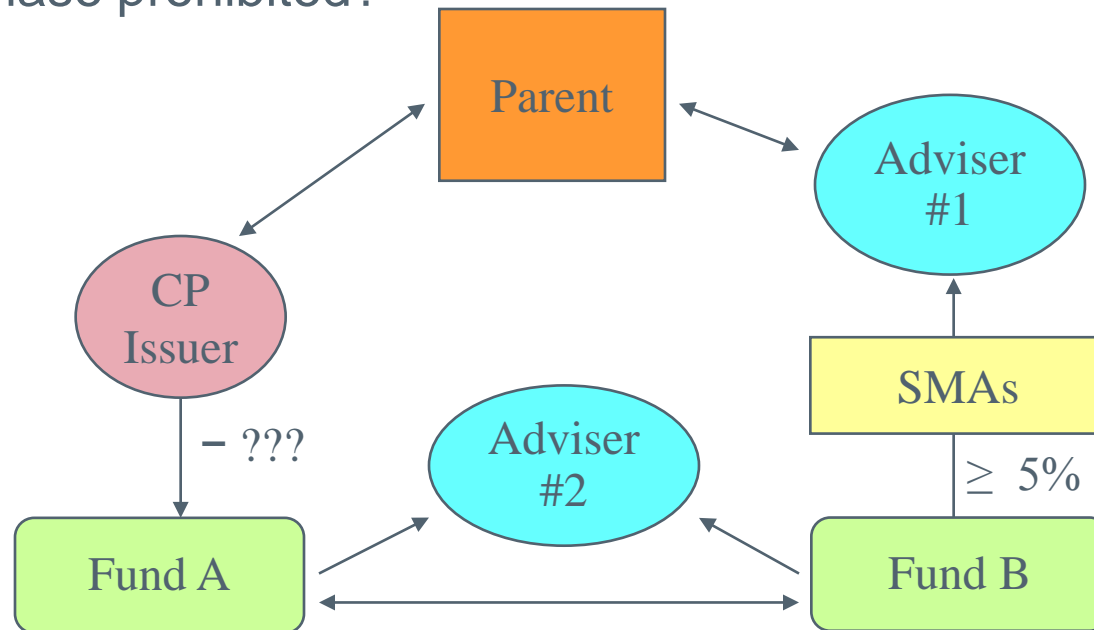
UPSTREAM AFFILIATE TRANSACTION

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



UPSTREAM AFFILIATE TRANSACTION (CONTINUED)

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. The SEC may collapse the holding company structure (CP Issuer = Adviser #1). Section 17(a)(1) prohibits CP Issuer from knowingly selling securities to Fund A (its second-tier affiliate).

TAKEAWAYS

- Be alert for potential affiliated transaction issues; violations can result in significant liability for a fund's investment adviser or other affiliate.
- Diagram the relationships to facilitate analysis.
- Talk it through with a knowledgeable colleague.
- Follow compliance procedures when effecting transactions in reliance on an exemptive rule or order.





Questions?



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