K&L GATES

MANAGING A FUND'S PORTFOLIO

I. INVESTMENT OBJECTIVES AND POLICIES OF INVESTMENT COMPANIES

A. **Investment Objectives**. A fund's investment objective is a short statement that describes what the fund seeks to achieve for its shareholders.

1. A fund's investment objective is sometimes deemed "fundamental" (meaning that it can be changed only with shareholder approval); investment objectives are not required to be fundamental.

2. A fund may have more than one objective; sometimes one objective is "primary" and the other is "secondary."

3. Funds are often classified by investment objective, *e.g.*, for purposes of performance comparisons.

4. Common types of funds and typical investment objectives and related investment policies are as follows:

   - aggressive growth fund – investment objective is "maximum capital appreciation," which the fund seeks to achieve through investments that often carry greater than ordinary risk;

   - growth fund – investment objective is "long-term growth of capital," which the fund seeks to achieve through investing primarily in common stocks;

   - growth and income fund – investment objectives are "long-term growth of capital and current income," which the fund seeks to achieve by investing primarily in common stocks that pay dividends;

   - income fund – investment objective is "current income," which the fund seeks to achieve by investing primarily in income producing securities;

   - high yield or income fund – investment objective is "high income," which the fund seeks to achieve by investing primarily in below investment grade "junk" bonds;

   - municipal bond or tax-exempt income fund – investment objective is "current income that is exempt from federal (and sometimes state) income taxes," which the fund seeks to achieve by investing primarily in municipal bonds; and

- money market fund – investment objective is "current income and conservation of principal," which the fund seeks to achieve by investing in high quality money market instruments.

B. Fundamental Policies

1. Certain policies are deemed to be fundamental, that is, changeable only upon the affirmative vote of a majority of the fund's outstanding voting securities (Sections 8(b) and 13 of the 1940 Act). The 1940 Act requires funds to set forth fundamental policies regarding the following types of activities:

   (a) the issuance of senior securities (Sections 8(b)(1)(C) and 13(a)(2)),

   (b) borrowing money (Sections 8(b)(1)(B) and 13(a)(2)),

   (c) underwriting of securities of other issuers (Sections 8(b)(1)(D) and 13(a)(2)),

   (d) concentration of investments in a particular industry or group of industries (Sections 8(b)(1)(E) and 13(a)(3)),

   (e) purchase or sale of real estate and real estate mortgage loans (Sections 8(b)(1)(F) and 13(a)(2)),

   (f) purchase or sale of commodities or commodities contracts (Sections 8(b)(1)(F) and 13(a)(2)),

   (g) making loans (Sections 8(b)(1)(G) and 13(a)(2)), and

   (h) other policies deemed by a fund to be fundamental (Sections 8(b)(3) and 13(a)(3)).

2. Fundamental policies must be included in a fund's initial registration statement, subsequent amendments, and, as appropriate, prospectuses.

3. Shareholder approval is required for changes in fundamental policies.

   (a) Section 13 provides that a registered investment company may not deviate from any fundamental policies set forth in response to Section 8(b) without a vote of a "majority of the outstanding voting securities" of the fund.

   (b) Section 13 also requires shareholder approval of a decision by the fund to cease to be an investment company. Note that a "majority of the outstanding securities" is defined in Section 2(a)(42) of the

1940 Act to mean the vote, at a meeting of the security holders of a company, of the lesser of (A) 67% or more of the voting securities present at such meeting, if the holders of more than 50% of the outstanding voting securities of such company are present or represented by proxy; or (B) more than 50% of the outstanding voting securities of such company.

(c) Section 13(b) contains special provisions for approval of changes by certain common law trusts.

C. <u>Fund Names</u>

1. Section 35(d) of the 1940 Act prohibits an investment company from using as part of its name any word or words which the SEC finds and by order declares to be deceptive or misleading. The SEC is authorized to bring an action alleging that the name or title of any registered investment company, or of any security it has issued, is materially deceptive or misleading.

2. Rule 35d-1 defines certain "materially deceptive or misleading" names for purposes of Section 35(d).

   (a) Rule 35d-1 prohibits the use of any name suggesting that the fund or its shares are "guaranteed" or "approved" by the U.S. Government. This prohibition includes use of any name that uses the terms "guaranteed" or "insured" or similar terms in connection with "U.S. government."

   (b) SEC staff guidance issued in 2013 also warned against fund names that suggest protection from loss. The staff specifically warned against using the term "protected" and acknowledged that it had requested name changes even where the fund explained the limitations of its "protection" in its prospectus. *See* SEC Staff Guidance Update No. 2013-12, (Nov. 2013).

3. Rule 35d-1 requires funds whose names suggest a particular investment emphasis (*e.g.*, a particular type of investment, or investments in a particular industry, country or geographic region) to have a policy that, under normal circumstances, at least 80% of fund assets (net assets plus amounts borrowed for investment purposes) be invested in that fashion.

4. If a fund has a name that implies that its distributions will be exempt from federal income tax, the fund must have a fundamental policy requiring that during periods of normal market conditions it will either:

   (a) invest its assets so that at least 80% of its income will be tax-exempt; or

   (b) have at least 80% of its net assets invested in tax-exempt securities.

5. Name Changes:

   (a) If a fund wishes to change its investment policy in a way that would require a name change, it must either obtain a shareholder vote or provide shareholders with at least 60 days notice of the change.

   (b) If a fund wishes to change its name, it also should consider carefully the laws of the state in which it is organized, its own organizational documents, and the steps required under each to effect a name change.

II. DIVERSIFICATION REQUIREMENTS

A. Securities Law Requirements

1. A "diversified" investment company must satisfy certain requirements under the 1940 Act.

   (a) At least 75% of the fund's total assets must be represented by (i) cash and cash items (including receivables), (ii) Government securities, (iii) securities of other investment companies, and (iv) securities of other issuers, provided that the investment represented by securities of other issuers does not exceed 5% of the total assets of a fund or 10% of the voting stock of the issuer. Section 5(b)(1).

   (b) For this purpose "Government security" is defined to mean "any security issued or guaranteed as to principal or interest by the United States, or by a person controlled or supervised by and acting as an instrumentality of the Government of the United States pursuant to authority granted by the Congress of the United States." Section 2(a)(16). The SEC staff, for this purpose, has interpreted Government securities to include repurchase agreements with private entities collateralized by Government securities, U.S. Treasury securities, Ginnie Mae and Fannie Mac.

2. If an investment company does not satisfy these requirements, it is a "non-diversified" company and must describe itself in the same manner. Its disclosures, if it is offering its securities to the public, must note that status and the risks thereof. *See* Form N-1A, Item 2; and Form N-2, Item 8. *See also* Section C.1, below, on the diversification provisions of the Internal Revenue Code.

3. Note that a fund is deemed "diversified" or "non-diversified" based not only on how it labels itself, but also on whether its portfolio actually meets the test of a diversified fund. This means that a fund that calls itself "non-diversified" but operates with a diversified portfolio might be deemed a diversified fund; if so, it would have to obtain a shareholder vote in order to return to non-diversified status. Rule 13a-1 under the 1940 Act essentially grants such a fund a three-year grace period during which it can return to non-diversified status without a shareholder vote, provided its disclosure documents have consistently described it as non-diversified during that time.

B. <u>Special Money Market Fund Portfolio Diversification</u>

1. A taxable or national tax-exempt money market fund may not invest more than 5% of its total assets in the securities (excluding government securities) of any one issuer. Rule 2a-7(d)(3)(i)(A).

2. A single state tax-exempt money market fund may not invest, with respect to 75% of its total assets, more than 5% of its total assets in securities of any one issuer. Rule 2a-7(d)(3)(i)(B).

3. A money market fund must limit its portfolio investments to dollar-denominated securities that the fund's board determines present minimal credit risks to the fund. Rule 2a-7(d)(2)(i) and Rule 2a-7(a)(11)(i).

C. <u>Federal Tax Law Requirements</u>

1. RIC Diversification Requirements.

   (a) In order to qualify as a regulated investment company ("RIC"), thereby providing it with several significant tax advantages, an investment company must meet the eligibility requirements set forth in Section 851 of the Internal Revenue Code.

   (b) Section 851(b)(3) addresses the requirements for diversification of an investment company's assets.

(i) 50% Diversification of Assets Requirement. At the close of each quarter of a RIC's taxable year, at least 50% of its gross assets must be invested in (a) cash and cash items, (b) U.S. government securities, (c) securities of other RICs, and (d) other securities provided that, it owns less than 10% of the outstanding securities of the issuer, and less than 5% of the investment company's assets are invested in the securities of the issuer. If the securities of an issuer owned by the investment company do not satisfy these tests, then none of the securities count towards the Section 851(b)(4) test.

(ii) 25% Diversification of Assets Requirement. At the close of each quarter of a RIC's taxable year, it may not have more than 25% of the value of its total assets invested in securities (other than government securities or securities of other RICs) of any one issuer or two or more issuers that the RIC controls and that are in the same, similar or related trades or businesses, or in the securities of one or more qualified publicly traded partnerships ("QPTPs"). In general, a QPTP is a publicly traded partnership (such as a master limited partnership) that derivates more than 10% of its gross income each year from sources that would not qualify under the RIC gross income test.

(iii) Market Fluctuation Exception. If a RIC's failure to meet a diversification requirement is due to market fluctuations or redemptions rather than to an acquisition, the RIC will not be disqualified if it had satisfied both diversification requirements at the close of the first quarter of the first year for which it elected to be a RIC.

(iv) 30-Day Cure Period. If failure to satisfy a diversification requirement at the close of any quarter is wholly or partly the result of an acquisition (including, in the case of a closed-end fund, a redemption or repurchase of its own securities), a RIC has 30 days after the close of the quarter in which to cure the failure.

(v) Other Failures. The Regulated Investment Company Modernization Act of 2010 added two additional cure provisions if the RIC is not able to cure the diversification failure within 30 days. First, for a "*de minimis* failure" – where assets with a total value of no more than 1% of the total value of the RIC's assets at the end of the quarter, or

$10 million (if less), cause the diversification failure – the RIC must dispose of assets in order to satisfy the diversification test or otherwise satisfy the diversification test within six months of the last day of the quarter in which the RIC identifies the failure. Second, for other failures, the failure must be due to reasonable cause and not to willful neglect. As above, the RIC must dispose of assets in order to satisfy the diversification test or otherwise satisfy the diversification test within six months of the last day of the quarter in which the RIC identifies the failure, and must also satisfy certain procedural requirements. For these failures, however, the RIC must pay a tax, at the current rate of 35%, on the net income generated by the assets that caused the RIC to fail the asset diversification test during the period for which the asset diversification test was not met (but the tax will be no less than $50,000).

III. REGULATION OF TRANSACTIONS INVOLVING REGISTERED INVESTMENT COMPANIES AND THEIR AFFILIATED PERSONS

A. The Concept of Affiliated Person

1. Introduction.

The 1940 Act and supporting SEC regulations contain detailed prohibitions and restrictions on transactions involving a registered investment company and its affiliated persons. These provisions are designed to limit self-dealing and conflicts of interest. They cover virtually all types of transactions that could be tainted by conflicts of interest. In administering the 1940 Act, the SEC and its staff have applied its requirements to a series of a "series company" as a separate investment company in virtually all circumstances. *IM Guidance Update*, No. 2014-06 (June 2014).

2. Definition of "Affiliated Person."

(a) Section 2(a)(3) defines an "affiliated person" of another person as:

- Any person directly or indirectly owning, controlling, or holding with power to vote, 5% or more of the outstanding voting securities of such other person;[1]

[1] The term "voting security" is defined in Section 2(a)(42) to mean "any security presently entitling the owner or holder thereof to vote for the election of directors of a company."

- Any 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;
- Any person directly or indirectly controlling, controlled by, or under common control with, such other person;
- Any officer, director, partner, co-partner, or employee of such other person;
- If such other person is an investment company, any investment adviser or member of an advisory board of the fund;[2] and
- If such other person is an unincorporated investment company not having a board of directors, the depositor of the fund.

3. Ownership.

(a) The 1940 Act does not contain a definition of ownership. For purposes of Section 2(a)(3) ownership can include both legal and beneficial ownership.

(b) Rule 13d-3 under the Securities Exchange Act of 1934 defines beneficial ownership based on voting power and/or investment power. Rule 16a-1 under the Exchange Act defines beneficial ownership based on direct or indirect pecuniary interest.

4. Definition of "Control."

(a) Section 2(a)(9) defines "control" to mean "the 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."

(b) Under Section 2(a)(9), there is a presumption of control on the part of any person who owns beneficially, either directly or through one or more controlled companies, more than 25% of the voting securities of the company. There is a presumption against control on the part of any person who does not so own more than 25% of the voting securities of a company; and there a presumption against a natural person being controlled. Any such presumption can be

[2] The definition of "investment adviser" in Section 2(a)(20) includes a sub-adviser of a fund.

rebutted by evidence but continues until a determination is made by the SEC.

(c) Funds in a fund complex may be deemed to be under common control and therefore affiliated persons of one another. "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).

B. Limitations on Transactions Involving Affiliated Persons

1. Principal Transactions Prohibited by Section 17(a).

(a) The legislative background of the 1940 Act and policy expressed in Section 1(b) demonstrates a Congressional determination to eliminate self-dealing, unfair transactions, or overreaching by affiliated persons of registered investment companies. The protections afforded elsewhere under the law and by the 1940 Act mandated independent directors are supplemented by specific proscriptions in Section 17 which address potential conflicts of interest:

(i) Section 17(a)(1) makes it unlawful for an affiliated person (or a principal underwriter), or an affiliated person of an affiliated person (or a principal underwriter), of a registered investment company knowingly to sell securities or other property to the fund or to any company controlled by the fund.

(ii) Section 17(a)(2) makes it unlawful for an affiliated person (or a principal underwriter), or an affiliated person of an affiliated person (or a principal underwriter), of a registered investment company knowingly to purchase securities or other property from the fund or from any company controlled by the fund (except securities of which the seller is the issuer).

(iii) Section 17(a)(3) makes it unlawful for an affiliated person (or a principal underwriter), or an affiliated person of an affiliated person (or a principal underwriter), of a registered investment company knowingly to borrow money or other property from the fund or from any company controlled by the fund (unless the borrower is controlled by the lender).

2. Statutory and Regulatory Exemptions from Section 17(a) Prohibitions.

   (a) Section 17(c) exempts from Section 17(a) a person who, in the ordinary course of business, sells to or purchases from any company merchandise or enters into a landlord-tenant relationship with any person and furnishes the services incident thereto.

   (b) Rules 17a-1 through 17a-6 exempt certain specified transactions otherwise prohibited by Section 17(a).

   (c) Rule 17a-7 exempts purchase or sale transactions between affiliated funds, and between funds and other advisory accounts affiliated solely by reason of having a common investment adviser, common directors and/or common officers, provided that the transaction:

      (i) is a purchase or sale, for no consideration other than cash payment against prompt delivery of a security for which market quotations are readily available;

      (ii) is effected at the independent "current market price" (as defined in the rule) of the security;

      (iii) no brokerage commissions, fee (except customary transfer fees), or other remuneration is paid in connection with the transaction; and

      (iv) the fund's board adopts procedures for effecting such purchase or sale transactions and determines at least quarterly that all such transactions were effected in compliance with such procedures.

   Reliance on the rule is conditioned on the fund's board satisfying the fund governance standards defined in Rule 0-1(a)(7).

   The SEC staff has issued a no-action letter indicating that the fund's board may rely upon a written representation from the fund's chief compliance officer that transactions effected in reliance on Rule 17a-7 complied with the procedures adopted by the board pursuant to that rule, instead of the board itself determining compliance. The relief also extends to transactions effected in reliance on Rule 17e-1 and Rule 10f-3. *Independent Directors Council*, SEC No-Action Letter (October 12, 2018).

(d) Rule 17a-8 exempts mergers, consolidations, and purchases or sales of substantially all of the assets between affiliated funds,[3] provided that:

(i) the board of each fund, including a majority of the independent directors, determines that the transaction is in the best interests of the fund and that the interests of existing shareholders will not be diluted as a result of the transaction; and

(ii) the above determinations and the bases therefor, including the factors considered by the directors, are recorded fully in the minute books of the funds.

The fund board must request and evaluate such information as may reasonably be necessary to its determinations, and consider and give appropriate weight to all pertinent factors. In addition, participation in the merger must be approved by vote of a "majority of the outstanding voting securities" (as defined in Section 2(a)(42)) of a merging fund, unless:

(i) no policy of the merging fund that under Section 13 could not be changed without shareholder approval is materially different from a policy of the surviving fund;

(ii) no advisory contract between the merging fund and any investment adviser thereof is materially different from an advisory contract between the surviving fund and any investment adviser thereof, except for the identity of the funds as a party to the contract;

(iii) the independent directors of the merging fund who were elected by shareholders will comprise a majority of the independent directors of the surviving fund; and

(iv) any 12b-1 fees authorized to be paid by the surviving fund are no greater (as a percentage of the fund's average net assets) than the 12b-1 fees authorized to be paid by the merging fund.

[3] The rule covers a merger of a registered investment company (or series thereof) and one or more other registered investment companies (or series thereof) or collective trust fund, common trust fund, or unregistered insurance company separate account.

Reliance on the rule is conditioned on the fund's board satisfying the fund governance standards defined in Rule 0-1(a)(7).

(e) Rule 17a-9 provides an exemption permitting a person to purchase securities from the portfolio of an affiliated money market fund. The purchase price must be paid in cash and must be equal to the greater of the amortized cost of the securities or their market price (in each case, including accrued interest).

If a security has not ceased to be an "eligible security" (as defined in Rule 2a-7) or defaulted, and the purchaser thereafter sells the security for a higher price than the purchase price paid to the fund, then the purchaser is required to pay such excess amount to the fund.

(f) Rule 17a-10 addresses fund complexes with multiple sub-advisers and multi-manager funds. It provides an exemption for a sub-adviser prohibited by Section 17(a) from entering into a transaction with a fund solely because the sub-adviser (or an affiliated person of the sub-adviser) provides investment advice to the fund or to another fund under common control. Rule 17a-10 permits:

(i) a sub-adviser to enter into transactions with an advised fund, but only with respect to a discrete portion of the advised fund for which the sub-adviser (or an affiliated person of the sub-adviser) does not provide investment advice; and

(ii) a sub-adviser to enter into transactions with a fund under common control with an advised fund that the sub-adviser (or an affiliated person of the sub-adviser) does not advise (*e.g.*, other funds in the fund complex).

The sub-advisory contracts must prohibit the sub-advisers from consulting with each other concerning transactions for the fund and, if both sub-advisers are responsible for providing investment advice to the fund, limit the sub-advisers' responsibility in providing advice to a discrete portion of the fund's portfolio.

(g) Rule 12d1-1 provides exemptions from Section 17(a) and Rule 17d-1 permitting a fund to purchase and redeem shares of an affiliated money market fund. The exemptions are conditioned on the acquiring fund not paying any sales charge or service fee in connection with the transaction, or the fund's adviser waiving its advisory fee in an amount necessary to offset any sales charge or service fee.

Rule 12d1-1 also permits an acquiring fund to pay commissions, fees, or other remuneration to a broker-dealer that is an affiliated person of the money market fund (a second-tier affiliated person) without complying with the quarterly board review and recordkeeping requirements of Rule 17e-1. However, this relief is available only if the broker-dealer and acquiring fund become second-tier affiliates solely because of the acquiring fund's investment in the money market fund.

Rule 12d1-1 covers investments in an unregistered money market fund provided that it operates like a registered money market fund. Thus, the rule requires:

(i) The unregistered money market fund to limit its investments to those in which a money market fund may invest under Rule 2a-7 and to undertake to comply with all the other provisions of Rule 2a-7;

(ii) The unregistered money market fund's adviser to be registered with the SEC as an investment adviser; and

(iii) The acquiring fund to reasonably believe that the unregistered money market fund operates like a registered money market fund and that it complies with certain provisions of the 1940 Act.

The SEC has indicated that an acquiring fund would reasonably believe that an unregistered money market fund was in compliance with these conditions if, for example, it received a representation from the fund (or its investment adviser) that the fund would comply with the relevant provisions in all material respects and if the acquiring fund had no reason to believe that the unregistered fund was not, in fact, complying with the relevant provisions in all material respects.

3. Exemptions under Section 17(b).

(a) If a transaction falls within the purview of Section 17(a) and is not covered by an exemptive rule, an application for an order under Section 17(b) exempting the proposed transaction from the provisions of Section 17(a) must be filed with the SEC and granted before the transaction is effected.

(b) The SEC will grant a Section 17(b) application and issue an order of exemption if evidence establishes that:

(i) the terms of the proposed transaction (including the consideration to be paid or received) are reasonable and fair and do not involve overreaching on the part of any person concerned;

(ii) the proposed transaction is consistent with the policy of each registered investment company concerned, as recited in its registration statement and reports filed under the 1940 Act; and

(iii) The proposed transaction is consistent with the general purposes of the 1940 Act.

(c) If a series of comparable transactions is involved, applicants may also seek an order pursuant to Section 6(c), which permits the SEC to exempt a class or classes of transactions from any provisions of the 1940 Act if and to the extent that such 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 1940 Act]."

4. Section 17(e) – Limitations on Commissions and Agency Transactions.

(a) <u>Actions as Agent for Funds</u>

(i) Section 17(e)(1) makes it unlawful for any affiliated person of a registered investment company, or any affiliated person of such person, acting as agent, to accept from any source any compensation (other than a regular salary or wages from such fund) for the purchase or sale of any property to or for the fund or any controlled company thereof, except if the person receiving the payment is acting in the course of his business as an underwriter or broker.

(ii) Absent the protection of the safe harbor provided by Section 28(e) of the Securities Exchange Act of 1934, a fund adviser's receipt of compensation under a client commission arrangement for the purchase or sale of any property, including securities, for or to the fund may constitute a violation of Section 17(e)(1). Disclosure of the arrangement would not cure any such violation.

(iii) It is not necessary to show that the person receiving the compensation for the purchase or sale of property to or for a fund influenced the action of the fund, or that the fund suffered economic injury. *United States v. Deutsch*, 451 F.2d 98, 109-10 (2d Cir. 1971), *cert. denied*, 404 U.S. 1019 (1972). For example, a fund's portfolio manager may violate Section 17(e)(1) merely by accepting a gift or entertainment from a broker-dealer used to purchase or sell the fund's portfolio securities. *IM Guidance Update,* No. 2015-01 (Feb. 2015).

(b) <u>Commissions Paid to Affiliated Brokers</u>

(i) Section 17(e)(2) prohibits an affiliated person of a registered investment company, or an affiliated person of such person, acting as broker, in connection with the sale of securities to or by the fund or any controlled company thereof, from receiving from any source a commission, fee, or other remuneration which exceeds:

(1) the usual and customary broker's commission if the sale is effected on a securities exchange; or

(2) 2% of the sale price if the sale is effected in connection with a secondary distribution of such securities; or

(3) 1% of the purchase or sale price of such securities if the sale is otherwise effected unless the SEC shall, in the public interest and consistent with the protection of investors, permit a larger commission.

(ii) Rule 17e-1 was adopted after the elimination of fixed, minimum commissions in 1975. The rule provides that, for purposes of (i)(1) above (*i.e.*, Section 17(e)(2)(A)), a commission shall be deemed not to exceed the "usual and customary broker's commission" if:

(1) it is reasonable and fair in comparison to what others are charging for comparable transactions involving similar securities being purchased or sold on an exchange during a comparable period of time;

(2) the fund's board, including a majority of the independent directors, (i) has adopted procedures

which are reasonably designed to provide that commissions paid by the fund are consistent with the above standard; and (ii) determines no less frequently than quarterly that all transactions effected pursuant to the rule were effected in compliance with such procedures; and

(3) the fund maintains a copy of the procedures, records of each transaction, and the information or materials upon which findings were made that transactions were effected in compliance with the required procedures.

Reliance on the rule is conditioned on the fund's board satisfying the fund governance standards defined in Rule 0-1(a)(7).

The SEC staff has issued a no-action letter indicating that the fund's board may rely upon a written representation from the fund's chief compliance officer that transactions effected in reliance on Rule 17e-1 complied with the procedures adopted by the board pursuant to that rule, instead of the board itself determining compliance. *Independent Directors Council*, SEC No-Action Letter (October 12, 2018).

5. Section 17(d) – Joint Transactions.

Section 17(d) prohibits any affiliated person of (or principal underwriter for) a registered investment company, or an affiliated person of such an affiliated person (or principal underwriter), from effecting or engaging in any transaction in which the fund is a joint or a joint and several participant in contravention of such rules as the SEC may prescribe. The provision is meant to minimize or prevent participation by a fund in a transaction on a basis different from or less advantageous than that of another participant.

(a) <u>Exclusion</u>

Any fund affiliate may act as manager of an underwriting syndicate or other group in which the fund is a participant and may receive compensation therefor.

(b) SEC Approval of Joint Arrangements

Rule 17d-1 provides that no affiliate, acting as principal, may participate in, or effect any transaction in connection with, any "joint enterprise or other arrangement or profit-sharing plan," unless an application for exemption from Section 17(d) has been approved by the SEC. The definition of "joint enterprise or other arrangement or profit-sharing plan" includes any written or oral plan, contract, authorization or arrangement, or any practice or understanding concerning an enterprise or undertaking whereby a fund and such affiliate have a joint or a joint and several participation, or share in the profits of such enterprise or undertaking, including, but not limited to, any stock option or stock purchase plan, but excluding any investment advisory contract subject to Section 15 of the 1940 Act.

(c) Exemptions

Rule 17d-1 exempts certain arrangements related to employee profit-sharing and similar plans. It also exempts:

(i) Arrangements regarding joint liability insurance policies, provided that:

(1) a fund's participation in the joint policy is in its best interests;

(2) the proposed premium to be allocated to the fund, based upon its proportionate share of the sum of the premiums that would have been paid if the insurance coverage were purchased separately by the insured parties, is fair and reasonable to the fund;

(3) the joint policy does not exclude coverage for bona fide claims made against any independent director, or against the fund if it is a co-defendant in a claim with the independent director, by another person insured under the policy;

(4) the fund's board, including a majority of the independent directors, determines no less frequently than annually that the standards of (1) and (2) have been satisfied; and

(5) the fund's board satisfies the fund governance standards defined in Rule 0-1(a)(7).

(ii) The assumption by a fund adviser of expenses incurred in connection with a merger, consolidation, or purchase or sale of substantially all of the assets of the fund.

(d) Service Contracts with Affiliates

The staff of the SEC formerly took the position that any contract between a fund and an affiliated person (other than an advisory contract subject to Section 15) may be a joint enterprise even if the parties are on opposite sides the contractual relationship. This assumption underlies a proposed safe harbor rule which was never adopted by the SEC and a series of staff no-action letters authorizing and imposing conditions on the engagement of affiliates to provide administration, custody, accounting, transfer agency, printing, and other services. However, the SEC staff has acknowledged that parties to a service contract are not presumed to be engaged in a joint enterprise if the service provider's compensation is not based on a share of the revenue generated by the service provider's efforts. *Norwest Bank Minnesota, N.A.*, SEC No-Action Letter (May 25, 1995).

6. Section 10(f) – Purchases During an Underwriting Syndicate.

(a) Prohibited Transactions

Section 10(f) supplements the Section 17 prohibitions of self-dealing and is designed to prevent an affiliated underwriter from "dumping" unwanted securities on a fund. Section 10(f) makes it unlawful for a registered investment company knowingly to acquire any security, during the existence of an underwriting syndicate, when a principal underwriter of the security is an officer, director, member of an advisory board, investment adviser, or employee of the fund or a person of which any such entity or person is an affiliated person.

(b) Exemption

Rule 10f-3 exempts any purchase of securities prohibited by Section 10(f) if the conditions of the rule are met. Among other conditions, the rule

(i) restricts the percentage of an offering that may be acquired by the fund and all other funds or accounts managed by its investment adviser (generally 25%);

(ii) prohibits fund purchases directly or indirectly from the affiliated underwriter. For this purpose, purchases from the syndicate manager are not deemed to be purchases from a specific underwriter if the underwriter does not benefit directly or indirectly from the transaction; and

(iii) requires that the fund's board adopt procedures for effecting such purchases and determine at least quarterly that all such purchases were effected in compliance with such procedures.

Reliance on the rule is conditioned on the fund's board satisfying the fund governance standards defined in Rule 0-1(a)(7).

The SEC staff has issued a no-action letter indicating that the fund's board may rely upon a written representation from the fund's chief compliance officer that transactions effected in reliance on Rule 10f-3 complied with the procedures adopted by the board pursuant to that rule, instead of the board itself determining compliance. *Independent Directors Council*, SEC No-Action Letter (October 12, 2018).

APPENDIX 1

Definition of "Affiliated Person"

(One-Way vs. Two-Way Affiliations)

Section 2(a) – When used in the 1940 Act, unless the context otherwise requires "affiliated person" of another person means:

One-Way Affiliations

Section 2(a)(3)(D):

"any officer, director, partner, co-partner, or employee of such other person;"

Section 2(a)(3)(E):

"if such other person is an investment company, any investment adviser thereof or any member of an advisory board thereof;"

Section 2(a)(3)(F):

"if such other person is an unincorporated investment company not having a board of directors, the depositor thereof."

Two-Way Affiliations

Section 2(a)(3)(A):

"any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding voting securities of such other person;"

Section 2(a)(3)(B):

"any person 5 per centum or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person;"

Section 2(a)(3)(C):

"any person directly or indirectly controlling, controlled by, or under common control with, such other person;"

IV. RESTRICTIONS ON ACQUISITION OF INSURERS AND SECURITIES-RELATED ISSUERS

Section 12 of the 1940 Act contains restrictions on the amount that investment companies may invest in securities issued by other investment companies, insurance companies, investment advisers, broker-dealers and underwriters.

A. Limitations on Investments in Other Investment Companies – Section 12(d)(1)

1. Section 12(d)(1)(A) generally prohibits any registered investment company (the "acquiring company"), and any company or companies controlled by such acquiring company, from purchasing any security issued by any other investment company (the "acquired company") if such purchase will result in the acquiring company or companies it controls owning in the aggregate (i) more than 3% of the outstanding voting stock of the acquired company; (ii) securities issued by the acquired company with an aggregate value in excess of 5% of the value of the acquiring company's total assets; or (iii) securities issued by the acquired company and all other investment companies (other than treasury stock of the acquiring company) with an aggregate value in excess of 10% of the value of the acquiring company's total assets.

2. Section 12(d)(1)(B) generally prohibits a registered open-end investment company from selling its securities to another investment company if immediately after the sale (i) more than 3% of the outstanding voting securities of the acquired company is owned by the acquiring company or (ii) more than 10% of the total outstanding voting securities of the acquired company is owned by the acquiring company and other investment companies.

3. The limitations contained within Section 12(d)(1) relate both to (a) the portion of the investment company's shares which is owned by the purchasing company and other investment companies and (b) the portion of the purchasing company's assets which is invested in the investment company and other investment companies.

4. The purpose underlying Sections 12(d)(1)(A) and (B) is to prevent investment companies from controlling other investment companies and creating complicated pyramid structures.

B. Limitations on Investments in Voting Stock of Insurance Companies – Sections 12(d)(2) and 12(g)

1. Sections 12(d)(2) and 12(g) of the 1940 Act, taken together, generally prohibit any registered investment company or companies controlled thereby from purchasing or otherwise acquiring any security issued by any insurance company if (i) the purchaser does not already own in the aggregate at least 25% of the outstanding voting securities of the insurance company or (ii) after the acquisition the investment company or companies controlled by it will own in the aggregate more than 10% of the insurance company's outstanding voting stock. This prohibition does not include a security received as a dividend or as a result of a plan of reorganization, unless the plan was devised to avoid the provisions of the sections.

C. Limitations on Investments in Securities of Investment Advisers, Broker-Dealers or Underwriters – Section 12(d)(3) and Rule 12d3-1

1. Section 12(d)(3) of the 1940 Act generally prohibits a fund from acquiring securities from an issuer which directly or indirectly (through a subsidiary, affiliate or otherwise) acts as a broker-dealer, underwriter, registered investment adviser or investment adviser to a registered investment company (*e.g.*, issuers in securities-related businesses).

2. Rule 12d3-1 provides an exemption from Section 12(d)(3). Under the rule, a fund may acquire securities issued by persons described in Section 12(d)(3) under the following circumstances:

   (a) A fund may acquire securities of an issuer that derives 15% or less of its gross revenues from the business of being a broker-dealer, underwriter or investment adviser.

   (b) A fund may acquire securities of an issuer that derives more than 15% of its gross revenues from such businesses if all of the following conditions are met:

      (i) the fund, as a result of the acquisition of any equity security, does not own more than 5% of the outstanding securities of that class of the issuer's equity securities, such equity security is a registered security and, at the time of acquisition, any equity security of the issuer acquired by the acquiring company is a "margin security" as defined by Federal Reserve System Regulations;

(ii) the fund, as a result of the acquisition of any debt security, does not own more than 10% of the outstanding principal amount of debt securities of such issuer and such debt securities are investment grade securities; and

(iii) the fund does not violate the percentage limitations on investments in the securities of any one issuer imposed by its own investment restrictions.

(c) Under no circumstances may a fund purchase any securities issued by (a) its investment adviser, (b) its distributor, (c) any affiliated persons of its adviser or distributor, or (d) any general partnership in a securities-related business.

V. LIQUIDITY – SECTION 22(e)

A. Section 22(e) of the 1940 Act essentially requires an open-end investment company (mutual fund) to honor a redemption request within seven days of receipt of the appropriate documents and not to suspend the right of redemption for more than seven days, except:

1. for any period (A) during which the New York Stock Exchange is closed other than customary week-end and holiday closings or (B) during which trading on the New York Stock Exchange is restricted; or

2. for any period during which an emergency exists as a result of which (A) disposal by the company of securities owned by it is not reasonably practicable or (B) it is not reasonably practicable for such company fairly to determine the value of its net assets; or

3. for such other periods as the SEC may by order permit for the protection of the security holders of the fund.

B. If a mutual fund holds a material percentage of its assets in securities or other assets for which there is no established market, there may be a question concerning the ability of the fund to:

1. establish fairly the net asset value of the shares being redeemed; or

2. make payment within seven days after the tender for redemption.

C. Rule 22e-4 imposes a limit on the acquisition of illiquid assets by mutual funds. The rule prohibits a fund from acquiring any illiquid investment if, immediately after the acquisition, the fund would have more than 15% of its net assets in illiquid investments that are assets. Rule 22e-4(b)(iv).

1. An illiquid investment is an investment not reasonably expected to be "sold or disposed of in current market conditions in seven calendar days or less without the sale or disposition significantly changing the market value of the investment," taking into account relevant market, trading, and investment-specific considerations and considering market depth. Rule 22e-4(a)(8).

    (a) A fund must report an occurrence of illiquid investment holdings exceeding 15% to its board within one business day "with an explanation of the extent and causes of the occurrence, and how the fund plans to bring its illiquid investments that are assets to or below 15% of its net assets…." Rule 22e-4(b)(iv)(A).

    (b) Additionally, if the amount of the fund's illiquid investments that are assets is still above 15% of its net assets 30 days from the occurrence, then the board must assess whether the plan presented to it continues to be in the best interest of the fund. Rule 22e-4(b)(iv)(B).

2. Typically, the investment adviser determines the liquidity of a fund's investments, subject to guidelines established by the fund board. *Investment Company Liquidity Risk Management Programs*, Investment Company Act Release No. 32315 (Oct. 13, 2016) (the "Adopting Release"), *available at* www.sec.gov/rules/final/2016/33-10233.pdf.

D. Under the new SEC Rule 22e-4, all fund boards are required to 1) approve a liquidity risk management program designed to manage the fund's liquidity risk and 2) designate a program administrator to oversee the program. Large fund complexes ($1 billion or more in total assets) must appoint an administrator by December 1, 2018, and approve a program by June 1, 2019. Smaller complexes (less than $1 billion in total assets) must appoint an administrator by June 1, 2019, and approve a program by December 1, 2019. Funds are not required to make a full portfolio classification of asset liquidity until June 1, 2019, and December 1, 2019, for large and small complexes, respectively.

VI. SENIOR SECURITIES – SECTION 18

A. Limits on Traditional Borrowing

Section 18 of the 1940 Act addresses the capital structure of registered investment companies and generally prohibits the issuance of senior securities, subject to the exceptions and further conditions in the section and rules thereunder. (Generally, subsections (a) - (e) apply to closed-end companies and subsection (f) applies to open-end companies.)

1. General prohibition on senior securities issued by open-end companies.

   Section 18(f) prohibits a registered open-end investment company from issuing any senior security.

   (a) Section 18(g) defines a senior security as "any bond, debenture, note, or similar obligation or instrument constituting a security and evidencing indebtedness, and any stock of a class having priority over any other class as to distribution of assets or payment of dividends ...."

   (b) Section 18(g)(1) states that a senior security does not include a borrowing from a bank which is "for temporary purposes only" and does not exceed 5% of the registered investment company's assets at the time the loan was made.

2. General prohibition on borrowing.

   (a) A registered open-end investment company using leverage may borrow only from a bank, provided the fund has "asset coverage" (as defined in Section 18(h)) at least equal to 300% of such borrowings. Section 18(f)(1).

   (b) A registered open-end investment company not using leverage for investment purposes may still borrow, but only from a bank and only for temporary purposes.

   (c) Under SEC orders of exemption, an open-end investment company can borrow from an affiliated open-end investment company under special conditions. See *In the Matter of Fidelity Fund, Inc., et al.*, Investment Company Act Release No. 12912 (Dec. 21, 1982).

3. Certain types of portfolio investments have the potential to create leverage. Leveraging of an investment company's portfolio magnifies the potential for gain or loss on monies invested and, therefore, results in an increase in the speculative character of the investment company's outstanding securities. The SEC has taken the position that the following activities may create leverage and are subject to Section 18.[4]

[4] See *Securities Trading Practices of Registered Investment Companies*, Investment Company Act Release No. 10666 (Apr. 18, 1979); *see also Dreyfus Strategic Investing & Dreyfus Strategic Income,* SEC No Action Letter (Jun. 22, 1987) and *Merrill Lynch Asset Management, L.P.,* SEC No-Action Letter (July 2, 1996).

(a) Futures contracts and options on futures contracts; forward commitment contracts, future commitments; and when-issued securities.

(b) The SEC has taken the position that it will not apply Section 18 restrictions to the above types of portfolio transactions if an investment company "covers" its positions or if it segregates assets sufficient to cover its obligations.

(c) Covering Transactions. The following are examples of covering transactions:

(i) To cover a long position in a futures contract: Purchase a put option on the same futures contract with a strike price at least as high as the price of the futures contract.

(ii) To cover the sale of a put option on a futures contract: Enter into a short futures position in the same futures contract or purchase a put option with a strike price at least as high as that of the option sold.

(iii) To cover a short position in a futures contract: Purchase the underlying instrument or purchase a call option on the futures contract at a price no higher than that of the short position.

(iv) To cover the sale of a call option on a futures contract: Purchase a call option on the same futures contract at a price no higher than the option strike price or purchase the underlying instrument.

(d) Segregated Accounts

(i) Liquid assets placed in an account, or marked as such, at least equal in value to the obligation undertaken by the investment company.

(ii) Long position in futures contracts and sale of put options: The segregated account must contain assets equal to the purchase price of the contract or the strike price of the option, less any margin on deposit.

(iii) Short position in futures contracts and sale of call options: The segregated account must contain assets in an amount which, when added to the margin on deposit, is equal to the market value of the instrument underlying the futures contract or call option, but not less than the option strike price or the price at which the short position was established.

(e) Derivatives and Senior Securities Rule Proposal

(i) On December 11, 2015, the SEC proposed new Rule 18f-4 to reduce leverage risks associated with derivatives and to achieve a more standardized treatment of derivatives transactions under the senior securities provisions of the 1940 Act.[5]

(ii) Proposed Rule 18f-4 has three main elements: (1) explicit limitations on portfolio leverage, (2) asset segregation requirements, and (3) derivatives risk oversight by fund management and the fund's board. Some of these elements are new, while others modify standards that exist under the current no-action regime.

(iii) The SEC did not propose a specific date by which funds must comply with Rule 18f-4, if adopted. Instead, the proposing release suggests a transition period during which funds could continue to rely on existing guidance while working towards compliance with the new requirements. The SEC would rescind existing guidance at the end of the transition period.

(iv) The future of proposed Rule 18f-4 is uncertain, as members of the Commission have criticized the proposal. The current SEC regulatory agenda includes a reproposal of the rule, suggesting that the SEC plans to take a different approach than what was described in the earlier proposal.

B. General Limitations on Leveraging by Closed-end Investment Companies

1. Section 18(a)(1)(A) prohibits a registered closed-end investment company from issuing any debt security unless it has asset coverage of at least 300% following the issuance.

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5 Investment Company Act Release No. 31933 (Dec. 11, 2015), *available at* www.sec.gov/rules/proposed/2015/ic-31933.pdf. A companion white paper, "Use of Derivatives by Investment Companies," by the SEC's Division of Economic Risk Analysis, is available at www.sec.gov/dera/staff-papers/white-papers/derivatives12-2015.pdf.

2. Section 18(a)(1)(B) prohibits a registered closed-end investment company from issuing any senior equity security unless it has asset coverage of at least 200% following the issuance of the stock.

3. Asset coverage for these purposes is defined by Section 18(h) and is determined on the basis of values calculated as of a time within 48 hours.

4. Maintenance of these asset coverage requirements is required pursuant to Section 18(a)(1)(C)(i).

5. In addition, Section 18(a)(1) requires that provision be made entitling the holders of such senior securities, as a class, to elect at least two directors of the fund at all times, and to elect a majority of the fund's directors if at any time dividends on the class of senior security are unpaid in an amount equal to two full years' dividends.

6. Section 18(c) makes it unlawful for a registered closed-end investment company to issue or sell any senior security representing indebtedness, if immediately thereafter the fund will have more than one class of senior security representing indebtedness, and to issue or sell any senior security which is a stock, if immediately thereafter the fund will have more than one class of senior security which is a stock.

VII. CODES OF ETHICS

Rule 17j-1 under the 1940 Act requires every registered investment company, and each investment adviser of or principal underwriter for such fund, to "adopt a written code of ethics containing provisions reasonably necessary to prevent its access persons[6] from engaging" in fraudulent practices.[7] The rule also imposes responsibilities on a fund's

[6] An "access person" is defined to include (a) any "advisory person" of a fund or its investment adviser and (b) any director, officer or general partner of a fund's principal underwriter who makes, participates in or obtains information regarding, the fund's portfolio transactions in the ordinary course of business, or whose functions or duties in the ordinary course of business relate to the making of any recommendations concerning these transactions. An "advisory person" of a fund or its adviser is defined to include any director, officer, general partner or employee of the fund or adviser (or of any company in a control relationship with the fund or adviser) who makes, participates in or obtains information regarding the fund's portfolio transactions in connection with such person's regular functions or duties, or whose functions relate to the making of any recommendations concerning these transactions. An advisory person also includes any individual in a control relationship to a fund or adviser who obtains information concerning recommendations made to the fund about portfolio securities transactions. All directors, officers and general partners of a fund are presumed to be access persons. If an investment adviser's primary business is advising funds or other advisory clients, all directors, officers and general partners of the adviser are presumed to be access persons of any fund advised by the adviser.

[7] Investment advisers also are subject to the code of ethics requirements of Rule 204A-1 under the Investment Advisers Act of 1940.

board with respect to code of ethics approval and oversight, reporting requirements on "access persons" and public disclosure requirements regarding codes of ethics and compliance procedures.

A. <u>Fraudulent Practices to be Prohibited</u>

1. Rule 17j-1 prohibits certain fraudulent practices by persons affiliated with registered funds, their investment advisers or their principal underwriters. Rule 17j-1 provides that any affiliated person of or principal underwriter for a fund, or any affiliated person of a fund's investment adviser or principal underwriter, in connection with the purchase or sale by the person of a security held or to be acquired by the fund, may not:

    (a) employ and devise, scheme or artifice to defraud the fund;

    (b) make any untrue statement of material fact or material omission to the fund;

    (c) engage in any act, practice, or course of business that operates or would operate as a fraud or deceit upon the fund; or

    (d) engage in any manipulative practice with respect to the fund.

2. Because the above concepts are difficult to apply factually and may take a variety of forms, the SEC has not defined in specific terms the acts or transactions that would constitute fraudulent or manipulative practices. Instead, the SEC's original adopting release suggested that ongoing scrutiny should be applied to conflict of interest situations in which:

    (a) "access persons are able to improperly gain personal benefit from their relationship with the fund;" and

    (b) "access persons through their position of influence over the fund" have an incentive to influence the investment strategy of the company for their personal benefit.

    For example, a conflict of interest may arise if an access person engages in personal transactions involving securities which he knows are held or to be acquired by the fund or are being considered for purchase or sale by the fund. The SEC did not prohibit all personal securities transactions involving this type of conflict of interest. Instead, the SEC required the adoption of codes of ethics to limit or prohibit transactions that warrant such regulation. Funds have wide latitude to determine what personal transactions, if any, in securities held by or suitable for investment by a fund should be permitted.

In the original adopting release, the SEC also noted that certain types of personal securities transactions by access persons, even though involving securities held or being considered for purchase or sale by the fund, are unlikely to present conflicts of interest or the potential for abuse. These include non-volitional transactions (such as automatic reinvestment programs), transactions unlikely to affect a highly institutional market and transactions not related economically to the fund's portfolio securities.

B. Board Approval of Code of Ethics

Rule 17j-1 requires that the board (including a majority of the disinterested directors) of a fund approve the code of ethics of the fund, and the codes of its investment adviser (including any sub-advisors) and affiliated[8] principal underwriter. The board must also approve any material change to the fund's, investment adviser's, or affiliated principal underwriter's code of ethics within six months of the change.

C. Compliance and Certification Report

Under Rule 17j-1, each fund, investment adviser and affiliated principal underwriter must provide a written report "no less frequently than annually" to the board that (a) describes any issues and material violations arising under the code since the last report and (b) certifies the adoption of procedures reasonably designed to prevent violations of the code.

D. Pre-Approval of Investments in IPOs and Private Placements

Rule 17j-1 provides that "investment personnel" of the fund or its investment adviser must obtain approval from their employer before acquiring any beneficial ownership in an initial public offering ("IPO") or limited offering (*i.e.*, a private placement). "Investment personnel" are (a) employees of the fund or adviser (or any company in a control relationship to the fund or adviser) who participate in making investment recommendations to the fund in connection with their regular functions or duties and (b) natural persons in a control relationship with the fund or adviser who obtain information about investment recommendations made to the fund.

E. Public Disclosure

Form N-1A requires that a fund must disclose in its prospectus or SAI (a) whether the fund, its investment adviser and its principal underwriter have adopted codes

[8] This is required if the principal underwriter is affiliated with the fund or its investment adviser or if any officer, director or general partner of the principal underwriter is an officer, director or general partner of the fund or its investment adviser.

of ethics, and (b) whether these codes permit personnel to invest in securities for their own accounts, including securities that may be purchased or held by the fund. In addition, a fund must file codes of ethics required by Rule 17j-1 as exhibits to the fund's registration statement.

F. Required Reports

Rule 17j-1 requires access persons to file initial and annual holdings reports and quarterly transaction reports with their employers reporting personal securities holdings and transactions in any security in which such access person has any direct or indirect "beneficial ownership." Each organization subject to Rule 17j-1 must identify access persons and notify them of their reporting obligations, adopt procedures for management or compliance personnel to review reports and establish a record of access persons who are required to make reports, and of persons who are responsible for reviewing those reports. Rule 17j-1 excludes from the reporting requirements any transactions effected for an account over which an access person has no direct or indirect influence or control. In addition, these reporting requirements are not applicable to access persons of unaffiliated principal underwriters.

1. Initial Holdings Report: Access persons must file a report with their employer disclosing the name, number of shares and principal amount of all securities in which they have any direct or indirect beneficial ownership and any securities account they maintain with a broker, dealer or bank within 10 days of becoming an access person.

2. Annual Holdings Report: Access persons must file an annual report with their employer disclosing the name, number of shares and principal amount of all securities in which the access person has any direct or indirect beneficial ownership and any securities account the access person maintains with a broker, dealer or bank.

3. Quarterly Transaction Reports: Rule 17j-1 requires access persons to file a quarterly report with their employers reporting personal securities transactions, including the date of the transaction, the name and number of shares, the principal amount of the securities involved, the nature of the transaction, the price at which the transaction was effected and the broker, dealer or bank with or through whom the transaction was effected. In addition, if the access person establishes a securities account during the quarterly period, the quarterly report must also disclose the name of the broker, dealer or bank with whom the account is established and the date the account is established.

4. Beneficial ownership: The standard for determining whether a report must be filed by an access person is whether the person has "any direct or

indirect beneficial ownership" in a security. The rule provides that beneficial ownership in this context should be interpreted in accordance with Rule 16a-1(a)(2) under the Securities Exchange Act of 1934. Generally, this rule provides that beneficial ownership of a security means having the opportunity, directly or indirectly, to profit or share in any profit derived from a transaction in the security, subject to certain exceptions specified in the rule.

G. Recordkeeping Requirements

Each fund, investment adviser and principal underwriter that is required to adopt a code of ethics or to which reports are required to be made by access persons are subject to the following recordkeeping requirements:

1. The current code of ethics, as well as a copy of any codes of ethics that were in effect at any time within the past five years, must be maintained in an easily accessible place;

2. A record of any violation of the code of ethics, and any action taken as a result of the violation, must be maintained for at least five years after the end of the fiscal year in which the violation occurs;

3. A copy of each report required to be made by an access person must be maintained for at least five years after the end of the fiscal year in which the information is provided, the first two years in an easily accessible place;

4. A record of all persons (currently or within the past five years) subject to Rule 17j-1's reporting requirements, or who are or were responsible for reviewing these reports, must be maintained in an easily accessible place;

5. A copy of each annual compliance and certification report must be maintained for at least five years after the end of the fiscal year in which it is made, the first two years in an easily accessible place; and

6. A record of the approval of, and rationale supporting, the acquisition of securities in IPOs and private placements for at least five years after the end of the fiscal year in which the approval is granted.

H. Exempt Securities and Funds

Securities issued by the government of the United States, bankers' acceptances, bank certificates of deposit, commercial paper, high quality short-term debt instruments (including repurchase agreements) and shares of registered open-end funds are exempt from the coverage of Rule 17j-1. The SEC staff has said it will interpret "high quality short-term debt instrument" to mean any instrument that has a maturity at issuance of less than 366 days and that is rated in one of the two highest rating categories by a nationally recognized rating organization.

The rule also provides that all money market funds or funds that limit their investments to exempted securities need not adopt codes of ethics pursuant to Rule 17j-1. Similarly, the investment advisers and principal underwriters of such funds need not adopt codes of ethics unless they also provide services to a fund that must adopt a code of ethics under the rule. Access persons of exempt funds and their investment advisers and principal underwriters are exempted from the rule's reporting requirements.

I. Staff Recommendations for Registered Investment Advisers

1) In 2013, the staff the SEC's Investment Adviser Regulation Office published an outline that described the regulation of investment advisers by the SEC. The outline contained a section on codes of ethics and stated that an investment adviser's code of ethics must, at a minimum, address:

    a) Standards of Conduct;

    b) Compliance with Federal Securities Laws;

    c) Personal Securities Transactions;

    d) Pre-approval of Certain Securities Transactions;

    e) Reporting Violations;

    f) Distribution and Acknowledgment; and

    g) Recordkeeping[9]

2) The SEC staff also issued guidance to investment advisers regarding personal securities trading by access persons in 2015. The staff recommended blind trusts as a method for preventing the misuse of material nonpublic information about an adviser's securities recommendations, client securities holdings and transactions.[10]

3) The SEC's Office of Compliance Inspections and Examinations ("OCIE") has noted that codes of ethics topics are among the five most frequent

[9] SEC Division of Investment Management, *Regulation of Investment Advisers by the U.S. Securities and Exchange Commission* (March 2013).

[10] SEC Division of Investment Management, Guidance Update No. 2015-03 (June 2015).

deficiencies identified during examinations.[11] Examples of deficiencies identified by OCIE include:

a) access persons not identified;

b) codes of ethics missing required information;

c) untimely submission of transactions and holdings; and

d) no description of code of ethics in Form ADVs.

J. Interpreting Rule 17j-1: Enforcement Actions

The following are examples of enforcement actions the SEC has brought against portfolio managers and their employers:

1. An action was brought against a portfolio manager for "taking an investment opportunity in a security without disclosing the opportunity to and obtaining the prior consent of the fund."[12] Additionally, the portfolio manager's employer was fined for failing to reasonably supervise its employee;

2. An action was brought against a portfolio manager for failing to report personal securities transactions, failing to preclear personal securities transactions and for trading on the same day as clients;[13] and

3. An action was brought against an investment adviser for failing to disclose to its clients the personal business relationships with issuers and persons related to issuers.[14]

4. An action was brought against an investment adviser for making misstatements about the firm's enforcement of its code of ethics and the firm's policy on acceptance of gifts.[15]

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11 SEC Office of Compliance Inspections and Examinations, Risk Alert Vol. VI, Issue 3 (Feb. 7, 2017).

12 *In the Matter of Ronald V. Speaker and Janus Capital Corporation*, Investment Advisers Act Release No. 1605 (Jan. 13, 1997).

13 *In the Matter of Roger W. Honour*, Investment Advisers Act Release No. 1527 (Sept. 29, 1995).

14 *In the Matter of Chancellor Capital Management*, Investment Advisers Act Release No. 1447 (Oct. 18, 1994).

15 *In the Matter of Jeffrey Slocum & Associates, Inc. and Jeffrey C. Slocum*, Investment Advisers Act Release No. 4647 (Feb. 8, 2017).

K. Examples of Acts and Practices that Might Violate Rule 17j-1

1. As a general guide, the following are situations and abuses which are covered by Rule 17j-1 and which should be examined by a compliance officer in reviewing the quarterly reports of personal securities transactions pursuant to Rule 17j-1.

   (a) Putting personal interests before fund interests, such as:

      (i) purchasing a promising stock for a personal account before purchasing the same stock for the fund, either to ensure availability of the stock before the fund invests or to obtain a more favorable price for a personal account than may later be available (especially after the market effect of purchases by the fund and others);

      (ii) conversely, selling a declining stock for a personal account before selling the same stock for the fund's portfolio, either simply to ensure that a personal loss is avoided first or to obtain a more favorable price for a personal account than may later be available (especially after the market effect of sales by the fund and others); and

      (iii) generally using economic, market or other investment information obtained by virtue of one's position with the fund's adviser (particularly information for which the fund is paying compensation) to advance a personal interest.

   (b) Personally competing in the market against the fund, such as: purchasing for a personal account while the fund is also seeking to acquire the same security.

   (c) Using knowledge of fund transactions to profit personally from the market effect of such transactions, such as: purchasing stock of a "hot issue" (in which demand for the stock exceeds supply) from an underwriter or broker-dealer pursuant to an understanding, formal or informal, that the underwriter or broker-dealer will be rewarded with fund portfolio brokerage or other business in exchange for making the stock available to the access person for a personal account.

2. Purchases and sales of a security include the purchase or writing of an option to purchase or sell the security, whether by the fund or the access person.

3. Not all violations of a code of ethics or all of the circumstances described above should trigger a presumption of abuse, manipulation or fraud of the type prohibited by Rule 17j-1. Some transactions may be inadvertent or have valid, independent, non-fraudulent purposes and may result in no actual harm to the fund or improper gain to the personal account. Furthermore, in situations in which improper benefit from market effects could otherwise be suspected, the trading volume of a given stock may be so great that the perceived market-effect abuse may not actually exist. Further investigation is necessary once such a circumstance or a similar pattern of activity is discovered. This investigation may include a discreet and confidential review of an access person's brokerage statements covering an expanded period of time, interviews with the access person and others; a review of patterns of fund transactions and of research provided to the fund; and a review of market activity in the affected securities.

4. Investment personnel should be prohibited from receiving any gift of more than *de minimis* value from any person that does business with the fund.

L. <u>Non-interested Board Members</u>

1. Rule 17j-1's general reporting requirements are reduced or eliminated for non-interested board members. Any director who is not an "interested person" of a fund within the meaning of Section 2(a)(19) of the 1940 Act, and would be required to make such a report solely by reason of being a fund director need not file (a) an initial or annual holdings report or (b) a quarterly transaction report, except where the director knew or, in the ordinary course of fulfilling his official duties as a fund director, should have known that during the 15-day period immediately before or after the director's transaction in a security such security is or was purchased or sold by the fund or the fund or its investment adviser considered purchasing such security.

2. Many fund complexes reduce the reporting burdens on non-interested board members by refraining from providing portfolio information to non-interested board members within the specified 15-day period. To eliminate most reporting by non-interested board members, every effort should be made to avoid providing such board members with information regarding prior and anticipated purchases and sales by the fund of particular securities until the expiration of 15 days from the date of the prior or anticipated transaction.

M. Violations and Sanctions

If transactions or practices are discovered that, after further investigation, are identified as a violation of the code of ethics or an abusive, fraudulent or manipulative practice, the facts relating to the matter should be disclosed to the fund's board. The board is obligated to impose whatever sanctions are deemed appropriate under the circumstances, which may include removal or suspension from office, censure and/or restitution to the fund of the amount equal to the advantage acquired (gain obtained or loss avoided) by the offender as a result of his act or practice.