

The logo for K&L GATES is displayed in white, bold, sans-serif capital letters on a dark blue rectangular background. The background of the entire slide features a complex financial data visualization with a world map, various line and bar charts, and scattered numerical values in shades of blue and white.

# K&L GATES

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## Registered Fund Developments

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# ETFs: Final Rule Update and Active Non-Transparent ETF Developments



# OVERVIEW OF THE ETF RULE

- On September 25, 2019, the SEC approved Rule 6c-11 under the 1940 Act (the “ETF Rule”) and related amendments to Form N-1A
  - The ETF Rule will rescind previously-issued exemptive orders of ETFs that are “permitted to rely” on it one year from its effective date
- The ETF Rule will allow the “vast majority” of ETFs to operate without obtaining an SEC exemptive order

Permitted to rely on the ETF Rule	Not permitted to rely on the ETF Rule
<ul style="list-style-type: none"> <li>• Index-based ETFs</li> <li>• Fully transparent active ETFs</li> </ul>	<ul style="list-style-type: none"> <li>• Non-transparent active ETFs</li> <li>• ETFs organized as UITs</li> <li>• Leveraged and inverse ETFs</li> <li>• Multi-class ETFs</li> </ul>



## OVERVIEW OF THE ETF RULE (CONT.)

- “Exchange-traded fund” – a registered open-end management company: (i) that issues (and redeems) creation units to (and from) authorized participants in exchange for a basket and a cash balancing amount if any; and (ii) whose shares are listed on a national securities exchange and traded at market-determined prices.
  - “Authorized participant” – a member of participant of a clearing agency registered with the Commission, which has a written agreement with the ETF or one of its service providers that allows the authorized participants to place orders for the purchase and redemption of creation units
  - “Basket” – the securities, assets or other positions in exchange for which an ETF (or in return for which it redeems) creation units
  - “Cash balancing amount” – an amount of cash to account for any difference between the value of the basket and the net asset value of a creation unit



# CONDITIONS OF THE ETF RULE

1. Each business day, an ETF must disclose certain information prominently on its website, which is publicly available and free of charge
  - Full portfolio transparency; daily premium/discount calculation; bid-ask spread information; premium/discount frequency table and amounts line graph
2. The portfolio holdings that form the basis for the ETF's next calculation of current NAV must be the ETF's portfolio holdings as of the close of business on the prior business day
3. An ETF must adopt and implement written policies and procedures that govern the construction of baskets and the process that will be used for the acceptance of baskets
  - Rule includes recordkeeping requirement for all AP agreements and baskets
4. The ETF may not seek, directly or indirectly, to provide investment returns that correspond to the performance of a market index by a specified multiple, or to provide investment returns that have an inverse relationship to the performance of a market index, over a predetermined period of time



# EXEMPTIONS GRANTED BY THE ETF RULE

- Exemption from Section 22(d) and Rule 22c-1 permits secondary market trading of ETF shares at market-determined prices
  - 2% limit on transaction fees consistent with Rule 22c-2
- Exemption provided from section 17(a)(1) and (a)(2) with regard to the deposit and receipt of baskets by a person who is an affiliated person of an ETF (or who is an affiliated person of such a person) solely by reason of: (i) holding with the power to vote 5% or more of an ETF's shares; or (ii) holding with the power to vote 5% or more of any investment company that is an affiliated person of the ETF
- Exemption from Section 22(e) permits delivery of foreign investments as soon as practicable but in no event later than 15 days after tender to the ETF
  - Only permitted to the extent that additional time for settlement is actually required, when a local market holiday (or series of consecutive holidays) or the extended delivery cycles for transferring foreign investments prevents timely delivery of foreign investment included in the ETF's basket



# CHANGES TO EXISTING ETF REGULATORY SCHEME

- No minimum creation unit size
- More detailed premium-discount disclosure and new bid-ask disclosure on website
- Basket flexibility
- No intraday indicative value (“IIV”) required
- All ETF shares deemed to be redeemable securities of open-end investment companies
  - Certain exemptions under Exchange Act become available to ETFs for secondary market transactions in ETF shares
  - SEC issued exemptive order granting other necessary relief for secondary market transactions in ETF shares



## KEY BOARD INTEREST

- Basket policy:
  - ETF Rule levels the playing field with regard to custom baskets
- Monitoring the effectiveness of the arbitrage mechanism via the bid-ask spread





# ACTIVE NON-TRANSPARENT ETFs

## 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.”

- Value arbitrage
- Hedge portfolio

## 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]”





# The SEC's Board Outreach Initiative



# SEC BOARD OUTREACH INITIATIVE OVERVIEW

- In December 2017, Director of Investment Management, Dalia Blass reported on an SEC initiative to engage in board outreach to review board responsibilities.
- In 2017, the Mutual Fund Directors Forum sent a letter to Chairman Clayton and the Independent Directors Council sent a letter to Blass requesting that the SEC prioritize modernizing and clarifying mutual fund directors' responsibilities.
- Blass reported that the Division of Investment Management is not seeking to shift responsibility away from boards, but is considering "if funds could benefit from recalibrating the 'what' and 'how' of board responsibilities."
- Since the initiative has been announced, Blass has been regularly attending fund complexes' Board meetings.



# SEC BOARD OUTREACH INITIATIVE OVERVIEW

- The SEC’s initiative is designed to “holistically revisit the responsibilities of the board” and “recalibrate” those responsibilities
- SEC Staff Framework for Board Responsibilities
  - Should a regulatory action require board engagement, and if so, what is the policy goal for the board’s involvement?
  - Is it necessary for the SEC to require a specific board action or can the SEC staff focus on a goal and let boards determine means of compliance?
  - Are prescribed board responsibilities consistent with the board’s oversight and policy role?
  - Are board responsibilities clear, up-to-date, and consistent with other regulatory actions?



# OUTCOMES OF THE OUTREACH INITIATIVE

- In Person Board Voting Requirements
  - SEC IDC No-Action Letter (Feb. 28, 2019)
- Affiliated Transactions Oversight
  - SEC IDC No-Action Letter (Oct. 12, 2018)
- Valuation & Board Responsibility
  - ABA Request for Clarification (July 22, 2019)



# IN PERSON BOARD VOTING

- SEC IDC No-Action Letter (Feb. 28. 2019)
- Staff would not recommend enforcement action if fund boards do not adhere to certain of the in-person voting requirements of:
  - Section 15(c) of the Investment Company Act of 1940, as amended (“1940 Act”) (investment advisory and principal underwriter agreement approvals and renewals);
  - Rule 12b-1 (regarding distribution plan approvals and renewals); and
  - Rule 15a-4(b)(2) (regarding certain interim advisory agreement approvals).



## IN PERSON BOARD VOTING

- Boards may now make either of the following types of approvals via telephone, video conference or other similar method:
  - Where the board members cannot meet in person due to unforeseen or emergency circumstances, a board may act, provided that (a) there are no proposed material changes to the relevant contract, plan or arrangement; and (b) the board ratifies the applicable approval at the next in-person meeting; or



## IN PERSON BOARD VOTING

- Where the board members previously “fully discussed and considered all material aspects” of the proposed approval at an in-person meeting but did not vote on the matter, a board may approve or renew an investment advisory agreement, principal underwriter agreement and Rule 12b-1 plan, approve an interim advisory agreement and select an independent auditor, provided that no board member requests another in-person board meeting.





## IN PERSON BOARD VOTING

- While somewhat limited in scope, the SEC's no-action letter provides increased flexibility in situations that may otherwise be burdensome for funds and their boards.



# AFFILIATED TRANSACTIONS OVERSIGHT

- SEC IDC No-Action Letter (Oct. 12, 2018)
- Staff would not recommend enforcement action if fund boards do not make certain finding required by several 1940 Act exemptive rules:



## AFFILIATED TRANSACTIONS OVERSIGHT

- No need for quarterly ratification of transactions covered by Rules 10f-3, 17a-7 or 17e-1 if a fund's board receives, no less than quarterly, a written representation from the chief compliance officer that transactions complied with the procedures adopted by the board pursuant to the relevant rule.



## AFFILIATED TRANSACTIONS OVERSIGHT

- SEC noted that its no-action position does “not change the board’s oversight role with respect to a fund’s overall compliance program,” but allows “boards to avoid duplicating certain functions commonly performed by, or under the supervision of, the CCO.”



## OTHER IDC RECOMMENDATIONS

- Permit boards to delegate to the fund's adviser the responsibility to determine fair value of securities, subject to the board's oversight;
- Modernize board responsibilities under Rule 12b-1 of the Act, *e.g.*, remove requirement that boards review Rule 12b-1 payments on a quarterly basis;
- Remove board responsibility under Rule 5b-3 to determine that issuers of securities serving as collateral in certain repurchase agreements are creditworthy and that the securities are liquid;
- Modernize Rule 17f-5 to allow directors to serve in an oversight role, rather than “be involved in the minutiae associated with the regular placement of foreign assets”;



## OTHER IDC RECOMMENDATIONS

- Remove board approval requirement for fidelity bonds, except in the case of joint bonds;
- Revise the requirement under Rule 18f-3 that boards make certain determinations in connection with class expense allocations, so that fund accountants and fund administrators make such determinations;
- Allow fund service providers to set the time for computing a fund's net asset value pursuant to Rule 22c-1, rather than requiring boards to do so; and
- Adopt an exemptive rule allowing directors to be considered "independent" if they hold only a nonmaterial or *de minimis* interest in a fund's unaffiliated subadvisers or their parent companies.



# VALUATION & BOARD RESPONSIBILITY

- ABA Request for Clarification (July 22, 2019)
- Prior SEC Guidance on Fair Value



## VALUATION & BOARD RESPONSIBILITY

- On July 22, 2019, a committee of the Business Law Section of the American Bar Association (“ABA”) submitted a letter to IM Director Blass and Paul Cellupica, the IM Deputy Director and Chief Counsel, regarding the SEC’s Board Outreach Initiative, one purpose of which is to reexamine the regulatory burdens placed on mutual fund boards.





## VALUATION: THE ABA LETTER

- The letter requests that the SEC staff take action to clarify the role and responsibilities of fund directors in fair valuation under Section 2(a)(41) of the 1940 Act in order to reflect current practices and the board's oversight role.
- The letter specifically asks the staff to provide that:



## VALUATION: ABA LETTER – NATURE OF DUTY & DISCHARGE

- directors' duties with respect to valuation matters are not subject to a different standard than other duties of directors under the 1940 Act
- directors have fully performed their duties under Section 2(a)(41) in good faith when the board fulfills its oversight responsibilities pursuant to Rule 38a-1, including by approving valuation policies and procedures that are reasonably designed



## VALUATION: ABA LETTER – RELIANCE & FAIR VALUE

- the board may reasonably rely on other parties, such as the fund's investment adviser, administrator or other appropriate parties, including the fund's independent registered public accounting firm, in fulfilling its statutory responsibilities
- no additional specific actions by the board are necessary for the board to fulfill its obligation to determine fair value



## VALUATION: ABA LETTER – SEC STANDARD

- When assessing directors' conduct in valuation matters, the SEC would recognize that
  - (a) the board's role is one of oversight, and
  - (b) it is expected that directors will exercise their reasonable business judgment in the performance of their oversight function.



## VALUATION: ABA LETTER – SEC PRIOR GUIDANCE

- Prior SEC or staff guidance could be inconsistent with the principles noted above.
- Any such guidance that may be interpreted to require that fund boards act in a management-like role rather than an oversight role in fulfilling their valuation responsibilities, would be superseded.



## PRIOR GUIDANCE ON FAIR VALUE

- In 2012, Doug Scheidt, then Associate Director and Chief Counsel of IM, stated that if a fair value is calculated in a manner not specified under a board approved methodology, the resulting fair value would not be viewed as having been determined by the board in accordance with the 1940 Act. He further has stated that in such a circumstance, a board would need to ratify or approve the fair value (and, presumably, the “new” methodology) in a timely manner (which may mean not waiting until the next board meeting).



## PRIOR GUIDANCE ON FAIR VALUE

### Oversight of Third-party Pricing Vendors

- In 2014, when the SEC adopted amendments to the rules governing money market funds, it inserted into the adopting release several pages of “guidance” on the role of fund boards in the valuation process. By its terms, this guidance was not limited to money market funds.



## PRIOR GUIDANCE ON FAIR VALUE

- The release noted that many pricing services do not simply report market prices; rather, they often provide prices that are calculated through some proprietary mechanism, such as a matrix, and/or they claim to provide “evaluated” prices.
- The release said that these prices are neither market prices nor fair values “as determined in good faith by the [fund’s] board of directors.”
- The release noted that boards can delegate aspects of the fair valuation process, but it asserted that in keeping with the board’s responsibility for fair valuation under the 1940 Act, the board may want to consider “the inputs, methods, models, and assumptions used by the pricing service,” and how those elements are affected as market conditions change.





## PRIOR GUIDANCE ON FAIR VALUE

- It noted that the board should consider the appropriateness of using evaluated prices as fair valuations of the fund's portfolio securities where the board "does not have a good faith basis for believing that the pricing service's pricing methodologies produce evaluated prices that reflect what the fund could reasonably expect to obtain for the securities in a current sale under current market conditions."
- Many fund boards have reacted to this pronouncement by inquiring more deeply into the processes, procedures and safeguards employed by the fund's outside pricing services, or – given the often complex mathematical modeling involved – consulting with others about the validity of the pricing services' approaches.





# Alternative Products and Registered Funds with Alternative Strategies



# REGISTERED FUNDS AND ALTERNATIVE INVESTMENTS

- During the post-crisis period of low interest rates, which continues, traditional fixed income investments have produced low interest income while many equity markets have exhibited volatility.
- Investor demand increased for “alternatives” to traditional equity and fixed income investments and strategies. Many advisers recommend such alternative allocations as part of an investor’s diversified investment portfolio.
- Advisers and “average” investors are comfortable with a traditional mutual fund form, and advisers seek alternative exposure for their clients. Registered funds thus have expanded the borders of traditional investments and strategies to meet demand.



# REGISTERED ALTERNATIVE PRODUCTS

- Registered alternative funds can utilize a variety of registered fund structures and formats, and can involve alternative assets as well as alternative investment strategies.
  - Liquidity of the assets/strategy are critically important in selecting an appropriate structure.
- Open-End Funds
  - Daily subscription and redemption
- Closed-End Funds
  - Exchange-listed funds (IPO)
  - Interval funds (continuously-offered)
  - Tender offer funds (continuously-offered)
    - Another consideration: publicly offered or privately placed?
- BDCs
  - Private
  - Public
    - Exchange-listed
    - Continuously offered



# REGISTERED FUNDS WITH ALTERNATIVE ASSET CLASSES OR STRATEGIES

- Mutual funds using “hedge fund” like strategies
  - Long/short equity funds
  - “Macro” funds using multi-manager, multi-strategy model
  - “Macro” multi-strategy fund of funds
  - Event-driven funds (special situations)
  - Event-linked funds (catastrophe bond)
  - Global macro/managed futures
  - Risk weighted multi-asset funds
  - Emerging market or frontier market investments
- Commodities exposure (also ETPs that are not investment companies)
- Energy master limited partnership funds (MLPs in open- and closed-end funds)
- Closed-end funds and illiquid and less liquid strategies
- **Although these strategies and asset classes involve creativity at work, registered funds do have distinct limits - there always will be hedge funds**



# MUTUAL FUNDS WITH “HEDGE FUND” STRATEGIES

- Long/short funds
  - Invest in long and short positions in securities
  - With a long position, the fund purchases a security outright; with a short position, the fund sells a security that it does not own and must borrow to meet its settlement obligations
  - Asset coverage requirements limit the amount of shorting by a registered fund
- Multi-manager, multi-strategy funds
  - Main adviser allocates fund assets to distinct sleeves managed by separate (often unaffiliated) sub-advisers
  - Sleeves may pursue same overall strategy using different sub-advisers, or different strategies
- Multi-strategy fund of funds
  - Access alternative investment strategies (e.g., convertible arbitrage, event driven (merger arbitrage), fixed income relative value, equity market neutral, long/short equity, global macro, managed futures and emerging markets) by allocating among in other investment companies
  - Similar objective to multi-manager, multi-strategy but using underlying funds



# MUTUAL FUNDS WITH “HEDGE FUND” STRATEGIES

- Event-driven funds (special situations/activism)
  - Invests in the securities of publicly traded companies involved in mergers, takeovers, tender offers, leveraged buyouts, spin-offs, liquidations, or similar events (“corporate reorganizations”).
  - A variety of strategies can be employed to capitalize on the mispricing of corporate securities during corporate reorganizations, including transactions involving common and preferred stock, debt instruments and derivative securities.
  - Strategies often involve the use of arbitrage, which involves taking advantage of small price differences between two otherwise equivalent assets.
  - Such strategies considered to be less dependent on the overall direction of stock prices.
  - Can be “activist” as well, where fund adviser lobbies management of portfolio companies for change.
- Event-linked funds (catastrophe bonds)
  - Return of principal and payment of interest contingent on the non-occurrence of a specified trigger event(s) that leads to economic and/or human loss, such as an earthquake of a particular magnitude or a hurricane of a specific category.
  - The most common type of event-linked bonds is known as “catastrophe” or “CAT” bonds.
  - In most cases, the trigger event(s) will not be deemed to have occurred unless the event(s) happened in a particular geographic area and was of a certain magnitude or caused a certain amount of actual or modeled loss. If the trigger event(s) occurs prior to a bond's maturity, the fund may lose all or a portion of its principal and forgo additional interest.
  - Liquidity of the CAT bond market is biggest challenge, although increasingly liquid.
  - Uncorrelated to equity or bond markets.



# MUTUAL FUNDS WITH “HEDGE FUND” STRATEGIES

- Global Macro/Managed Futures
  - Focus on investing in instruments whose prices fluctuate based on the changes in economic policies, along with the flow of capital around the globe - instruments move based on systemic risk rather than security specific
  - In general, focus on trading futures in currency strategies, interest rates strategies, and stock index strategies
  - To run as a RIC, must use offshore subsidiary for any commodities futures that produce “bad income”
  - Utilize inherent or “economic” leverage in futures typically with programmatic trading
  - Asset coverage requirements
  - CFTC has “harmonized” requirements for such funds, which also are commodity pools
- Risk weighted multi-asset funds
  - Focuses on allocation of risk among asset classes
  - Goal is to earn the steady level of return with less volatility and overall risk, or to realize better returns with an equal amount of risk and volatility (versus traditional asset allocation strategies)
  - May use pre-determined asset class allocation or dynamic balancing
  - If using futures/derivatives, asset coverage issues
- Emerging market and frontier market investment
  - Focus on securities of non-government issuers in developing countries
  - Liquidity may be an issue





# COMMODITIES EXPOSURE

- Commodity RICs
  - Often similar/same as “managed futures” funds but focused on commodities futures rather than financial futures
  - Must use offshore subsidiary structure to be a RIC
  - Asset coverage requirements
  - CFTC regulation/harmonization
- Commodity ETPs (exchange traded products)
  - Pool that holds only physical commodity (i.e., gold, silver, copper)
  - **Neither an investment company nor a commodity pool**
  - Exchange-traded issuer like a public company



# MLPS – MASTER LIMITED PARTNERSHIPS

- MLPs are “master limited partnerships” mainly in the energy/resources areas.
  - MLPs are generally publicly traded, are regulated by the SEC and must make public filings like any publicly traded corporation.
  - Midstream MLPs also may operate ancillary businesses including marketing of energy products and logistical services. The MLPs in which a fund invests also may engage in owning, managing and transporting alternative energy assets, including alternative fuels such as ethanol, hydrogen and biodiesel.
- MLPs are generally treated as partnerships for U.S. federal income tax purposes.
  - Some MLPs are registered investment companies that operate as “C corporations” rather than as a RIC.
  - To be treated as a partnership for U.S. federal income tax purposes, an MLP must derive at least 90% of its gross income for each taxable year from qualifying sources, including activities such as the exploration, development, mining, production, processing, refining, transportation, storage and certain marketing of mineral or natural resources.
- A RIC is limited to 25% direct holding of MLPs. Registered funds that are RICs must diversify assets into MLPs, related companies or exposure to such companies through other instruments.



# KEY LEGAL ISSUES FOR REGISTERED ALTS

- Important legal considerations for registered alternative funds include:
  - Asset/Strategy Liquidity
  - Senior Securities Limitations
  - Valuation
  - Tax Matters
  - Distribution and Sales Practices
  - CFTC Regulatory Compliance
  - Fund-of-Funds Limitations
  - Disclosure





# Fund of Funds



## SEC RULEMAKING AND GUIDANCE

- Fund of Funds Rule – Rule 12d1-4 proposed December 2018
- Derivatives Rule – Rule 18f-4 proposed December 2015
- Expedited Exemptive Applications – Rule 0-5 proposed October 2019
- SEC Guidance Updates on Disclosure/Filings



## RULE 12d1-4: RESET FOR FUND OF FUNDS

- The rule and amendments are intended to streamline the mix of exemptive rules, exemptive orders and interpretive relief governing FOF arrangements and to establish a consistent framework and uniform conditions
- The rule would expand the types of permissible FOF structures but would require many existing FOFs to restructure
- Funds of affiliated funds generally would have to comply with new conditions if they would like flexibility to invest in unaffiliated funds (other than money market funds) or directly in non-fund assets



## RULE 12d1-4: RESET FOR FUND OF FUNDS

- FOF arrangements are subject to various restrictions under both the 1940 Act and SEC rules
- Regulation designed to curb abuses that could arise in fund of fund structures
  - “Pyramiding” – complex structures and investor confusion
  - Potential for excessive layering of fees
  - Abuse of control arising from the concentration of voting power in the acquiring investment company



## RULE 12d1-4: RESET FOR FUND OF FUNDS

- Section 12(d)(1) prohibits registered funds from investing in another investment company beyond the “3/5/10 Limits”:
  - Investing fund can't purchase more than 3% of another fund's total outstanding shares
  - Investing fund can't invest more than 5% of its total assets in another fund
  - Investing fund can't invest more than 10% of its total assets in other funds in the aggregate





## RULE 12d1-4: RESET FOR FUND OF FUNDS

- Proposed Rule 12d1-4 would allow any registered fund or BDC to invest in any other registered fund or BDC beyond the 3/5/10 limits, subject to conditions regarding:
  - control and voting – requires pass through or mirror voting if investing fund owns more than 3% of an unaffiliated fund
  - restricted redemptions – most controversial provision
  - excessive fees – adviser must make annual findings and report to fund board
  - complex structures – two-tier limit



## RULE 12d1-4: REDEMPTION RESTRICTIONS

- Proposed Rule 12d1-4 would prohibit an acquiring fund from redeeming (or submitting for redemption or tendering for repurchase) more than 3% of an acquired fund's total outstanding shares in any 30-day period
  - Mandatory
  - Applies to acquiring funds invested in affiliated funds, a significant change from current practice
  - Raises liquidity concerns, particularly during periods of market stress or volatility
  - Does not apply to FoFs relying on Section 12(d)(1)(G)



## RULE 12d1-4: REDEMPTION RESTRICTIONS

- Proposed amendments would allow funds relying on Section 12(d)(1)(G) – that is, affiliated FOF structures (e.g., many target date funds) – to continue to invest in unaffiliated money market funds
  - Cash sweep arrangements do not raise same concerns surrounding fund of funds structures
  - But aside from money market funds, these fund of funds' other investments would be limited to cash, short-term paper and government securities, unless they choose to rely on new Rule 12d1-4 and its new conditions, including the restrictive redemption provision





# Derivatives Rule



## DERIVATIVES RULE – RULE 18f-4

- The rule would replace the existing asset segregation regime developed over the last 35+ years
- The rule would limit the way mutual funds, closed-end funds, and ETFs use derivatives and establish required risk management measures
- Portfolio limitations
- Asset segregation
- Risk management program
- Disclosure and reporting



## DERIVATIVES RULE – RULE 18f-4

- 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



# 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 FOR DERIVATIVES 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
- Qualifying assets for financial commitment transactions
  - Must be convertible to cash prior to the date the obligation becomes payable





# 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
- Heavy comments; commenters posited that the rule was too restrictive





# Other Developments



## EXPEDITED EXEMPTIVE APPLICATIONS (PROPOSED)

- Establish an expedited review procedure for routine exemptive applications that are substantially identical to recent precedent
- Expedited review available if the application is substantially identical to two other applications for which an order was issued within the past two years
- Notice issued no later than 45 days from the date of filing unless applicants are not qualified under the rules or if the staff believes comments are necessary
- For non-expedited applications, establish 90 timeframe for staff to take action on application or amendment
- Make comments and responses public within 120 days after disposition (similar to disclosure filings)



## STAFF GUIDANCE UPDATES - DISCLOSURES

- ADI 2019-08 -- Improving Principal Risks Disclosure
- SEC staff “strongly encourage[s]” funds to list their principal risks in order of importance, rather than alphabetically
- In some cases, listing risks alphabetically could obscure most important risks and render disclosures misleading
- Alert is not binding legal authority - represents the first time that the SEC staff has provided written guidance on this topic



## STAFF GUIDANCE UPDATES - DISCLOSURES

- ADI 2019-07 - Review of Certain Filings Under Automatic Effectiveness Rules
- SEC staff “urges” registrants to contact the SEC staff prior to making Rule 485(a) filings raising “unique or particularly novel issues”
- SEC staff “requests” registrants to respond to staff comments on Rule 485(a) filings at least five business days prior to such filings becoming automatically effective
- Requests registrants to file delaying amendments if comments can’t be resolved





# Proxy Voting



## SEC GUIDANCE – AUGUST 2019

- In September 2018, the SEC withdrew two 2004 no-action letters that made it easier for advisers to rely on the voting recommendations of proxy advisory firms
- On August 21, 2019, the SEC issued Q&A guidance on proxy voting by investment advisers, including their use of proxy advisory firms
- On the same day, SEC's Division of Corporate Finance issued guidance providing that proxy voting advice generally constitutes a solicitation under the federal proxy rules



# SEC GUIDANCE – INVESTMENT ADVISERS

- scope of authority and responsibilities to vote proxies
- how to demonstrate that voting determinations are in the client's best interest and follow procedures
- considerations that an investment adviser should take into account if it utilizes a proxy advisory firm
- evaluating a proxy advisory firm's services
- dealing with potential errors or methodological weaknesses in a proxy advisory firm's analysis
- whether an investment adviser is required to exercise every opportunity to vote a proxy for the client for which it has assumed voting authority (advance agreement or cost/benefit analysis)





## GUIDANCE – PROXY ADVICE FIRMS

- Proxy advisory firms' recommendations would generally amount to the “solicitation” of a proxy under the proxy rules but, if the proxy adviser follows certain provisions, such advice is exempt from the proxy solicitation rules, except Rule 14a-9 (anti-fraud provision)
- Disclose:
  - methodologies used to formulate its voting advice (if omission would render advice misleading),
  - proxy voting advice based on non-public disclosures, and
  - material conflicts of interest.



# PROPOSED RULES

- On November 6, 2019, the SEC proposed rule amendments modifying
  - the requirements to submit and resubmit shareholder proposals
  - the rules governing proxy solicitations
- The SEC is promulgating the rules in the midst of an active debate between the investor community and publicly traded companies on the role of shareholder proposals, in particular in the context of so-called environmental, social, and governance (“ESG”) proposals



# SHAREHOLDER PROPOSALS

- Proposed amendments would heighten the eligibility criteria to submit a proposal for inclusion in an issuer's proxy statement by creating a three-tiered system based on the value of shares owned and the duration of ownership
- Currently, shareholders who own continuously \$2,000 or one percent of a company's securities for one year may submit a proposal
- The proposed amendments would (1) eliminate the one percent ownership criteria; (2) increase the \$2,000 threshold to \$25,000; and (3) allow shareholders who own continuously \$15,000 of securities for at least two years or \$2,000 for three years to submit a proposal
- Would also revise the submission and resubmission thresholds and impose additional requirements



# PROXY VOTING ADVICE

The amendments would:

- Modify existing information and filing requirement exemptions for proxy voting advisors
- Allow issuers a second chance to review voting recommendations
- Codify the SEC's recent guidance that unsolicited proxy voting advice is a solicitation under Rule 14a-1(I), but that voting advice provided in response to an unprompted request is not a solicitation



K&L GATES