

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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## Transactions with Affiliates

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# LEGISLATIVE POLICY

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

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

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





Who is an affiliate?

# AFFILIATED PERSON – Section 2(a)(3)

## One-Way Affiliations

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

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



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

### Two-Way Affiliations

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

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



# OWNERSHIP

Ownership is not defined in the Investment Company Act; both legal and beneficial ownership can apply.

- Exchange Act Rule 13d-3 defines “beneficial owner” based on:
  - Voting power; and/or
  - Investment power
- Exchange Act Rule 16a-1 defines “beneficial owner” based on:
  - Direct or indirect pecuniary interest



## CONTROL – Section 2(a)(9)

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

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



# FUND COMPLEX AFFILIATIONS

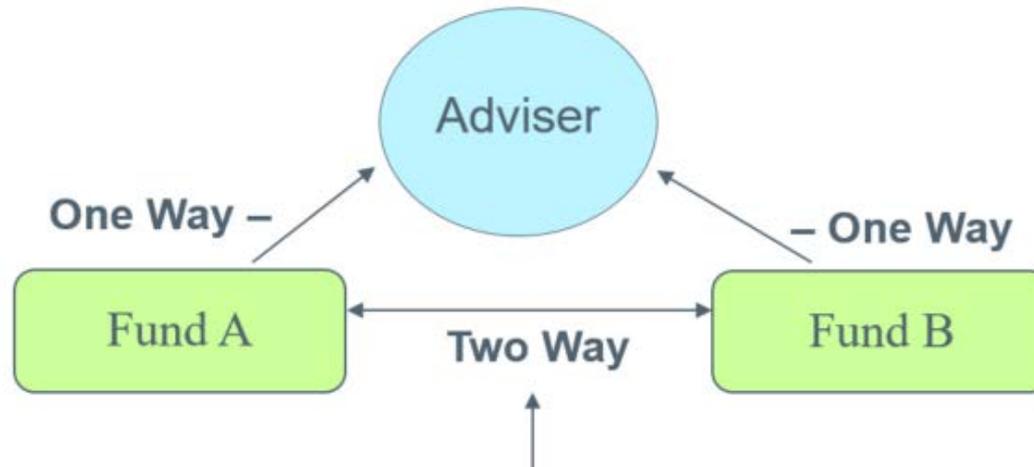
*“Investment companies with a common investment adviser are not necessarily under ‘common control’ and, therefore, are not necessarily affiliated persons solely for this reason. However, the nature of the advisory relationship has been considered to carry with it a strong indication of control.” FundTrust,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

- The determination whether investment companies with the same investment adviser are affiliated depends in each case on the particular facts and circumstances presented.
- Funds under “*common control*” may be deemed to be first-tier affiliates of one another.



# FUND COMPLEX AFFILIATIONS

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



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





What are the categories of prohibited transactions?

# CATEGORIES OF PROHIBITED TRANSACTIONS

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



# PRINCIPAL TRANSACTIONS

Section 17(a) prohibits first-tier and second-tier affiliates of a fund, acting as principal, from:

- 1) Knowingly selling any securities or other property (except fund shares) to the fund;
- 2) Knowingly purchasing any securities or other property (except fund shares) from the fund;
- 3) Borrowing money or other property from the fund; or
- 4) Lending money or other property to the fund in contravention of SEC regulations.



## PRINCIPAL TRANSACTIONS *(CONTINUED)*

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

- Rule 17d-1(c) defines such joint arrangements as:

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



# AGENCY TRANSACTIONS

Section 17(e) prohibits first-tier and second-tier affiliates of a fund:

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



# UNDERWRITINGS

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

- Officer
- Director
- Advisory board member
- Investment adviser (or sub-adviser)
- Employee, or
- A person of which any of the above is a first-tier affiliate.





# How can funds seek exemptions for affiliated transactions?

# SEC EXEMPTIVE AUTHORITY

Section 17(b) provides that the SEC may, upon application by any person, issue an order permitting a prohibited principal transaction. The SEC must find that the transaction is:

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



## SEC EXEMPTIVE AUTHORITY *(CONTINUED)*

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

- Necessary or appropriate in the public interest; and
- Consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Investment Company Act.



## SELECT EXEMPTIVE RULES

- Rule 17a-7 – Portfolio Cross Transactions
- Rule 17a-8 – Fund Reorganizations
- Rule 17a-10 – Sub-advised Funds
- Rule 17d-1(c) – Certain Joint Arrangements
- Rule 17e-1 – Affiliated Brokerage Transactions
- Rule 10f-3 – Underwriting Syndicate Transactions



# PORTFOLIO CROSS TRANSACTIONS

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

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



## RULE 17a-7 CONDITIONS

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



## RULE 17a-7 CONDITIONS *(CONTINUED)*

- The fund board (including a majority of the independent directors) must:
  - Adopt procedures which are reasonably designed to provide that all of Rule 17a-7's conditions will be complied with; and
  - Receive, at least quarterly, a written representation from the fund's chief compliance officer that transactions effected in reliance of Rule 17a-7 complied with Board's adopted procedures\*
- The fund board must satisfy the “*fund governance standards*” defined in Rule 0-1(a)(7).

\*See recent SEC Staff no-action letter to *Independent Directors Council* (Oct. 12, 2018)



# FUND REORGANIZATIONS

Rule 17a-8 permits reorganization transactions between:

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



## RULE 17a-8 CONDITIONS

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



## RULE 17a-8 CONDITIONS *(CONTINUED)*

- Approval by an acquired fund's shareholders is required, unless:
  - The fundamental policies of the surviving fund are not materially different;
  - The advisory contact of the surviving fund is not materially different;
  - A majority of the surviving fund's independent directors will be comprised of independent directors elected by the acquired fund's shareholders; and
  - 12b-1 fees authorized to be paid by the surviving fund are no greater than those authorized to be paid by the acquired fund.



## SUB-ADVISED FUNDS

Rule 17a-10 permits a sub-adviser (or an affiliated person of the sub-adviser) to enter into transactions

- With advised funds, only to a discrete portion of the advised fund for which sub-adviser does not provide investment advice; or
- With a fund under common control that the sub-adviser does not advise.



## RULE 17a-10 CONDITIONS

Advisory contracts must prohibit sub-advisers from consulting each other regarding transactions for the fund.

- If both sub-advisers provide investment advice to the fund, the contract must limit each sub-adviser's responsibility to a discrete portion of fund portfolio.



# CERTAIN JOINT ARRANGEMENTS

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

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



# AFFILIATED BROKERAGE

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

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



# RULE 17e-1 CONDITIONS

- Commissions paid by the fund must be reasonable and fair in comparison to what other brokers receive in connection with comparable transactions.
- The fund board (including a majority of the independent directors) must:
  - Adopt procedures which are reasonably designed to provide that commissions paid to an affiliated broker are consistent with the standard above; and
  - Receive, at least quarterly, a written representation from the fund's chief compliance officer that transactions effected in reliance of Rule 17e-1 complied with Board's adopted procedures\*
- The fund board must satisfy the “*fund governance standards*” defined in Rule 0-1(a)(7).

\*See recent SEC Staff no-action letter to *Independent Directors Council* (Oct. 12, 2018)



# UNDERWRITING SYNDICATE TRANSACTIONS

Rule 10f-3 provides an exemption to Section 10(f), which prohibits funds from acquiring securities during the existence of an underwriting syndicate when the principal underwriter is a fund

- Officer or Director
- Advisory board member
- Investment adviser (or sub-adviser)
- Employee, or
- A person of which any of the above is a first-tier affiliate.



# RULE 10f-3 CONDITIONS

- Under Rule 10f-3, funds may acquire securities during the existence of an underwriting syndicate that would be prohibited by Section 10(f), but, among other conditions, the rule:
  - Restricts the percentage of an offering acquired by the fund and other funds managed by its investment adviser (generally up to 25%)
  - Prohibits purchases directly or indirectly from an affiliated underwriter



## RULE 10f-3 CONDITIONS *(CONTINUED)*

- The fund board (including a majority of the independent directors) must:
  - Adopt procedures which are reasonably designed to provide that all of Rule 10f-3's conditions will be complied with; and
  - Receive, at least quarterly, a written representation from the fund's chief compliance officer that transactions effected in reliance of Rule 10f-3 complied with Board's adopted procedures\*
- The fund board must satisfy the “*fund governance standards*” defined in Rule 0-1(a)(7).

\*See recent SEC Staff no-action letter to *Independent Directors Council* (Oct. 12, 2018)



# TAKEAWAYS

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



Questions?

