K&L GATES

2019 New York Investment Management Conference

Registered Fund Developments

Derek N. Steingarten, Partner, New York
Peter J. Shea, Partner, New York
Fatima S. Sulaiman, Partner, Washington, DC

The ETF Rule

K&L GATES

OVERVIEW

- Background
- Overview of the Rule
- Exemptions Granted by Rule
- Changes Made by Rule to Current ETF Regulatory Scheme
- Key Board Interests

BACKGROUND

- On September 25, 2019, the SEC approved Rule 6c-11 under the Investment Company Act of 1940 (the “Rule”) and related amendments to Form N-1A (“Disclosure Amendments”)
- The Rule will rescind previously-issued exemptive orders of ETFs that are “permitted to rely” on it one year from its December 23, 2019 effective date

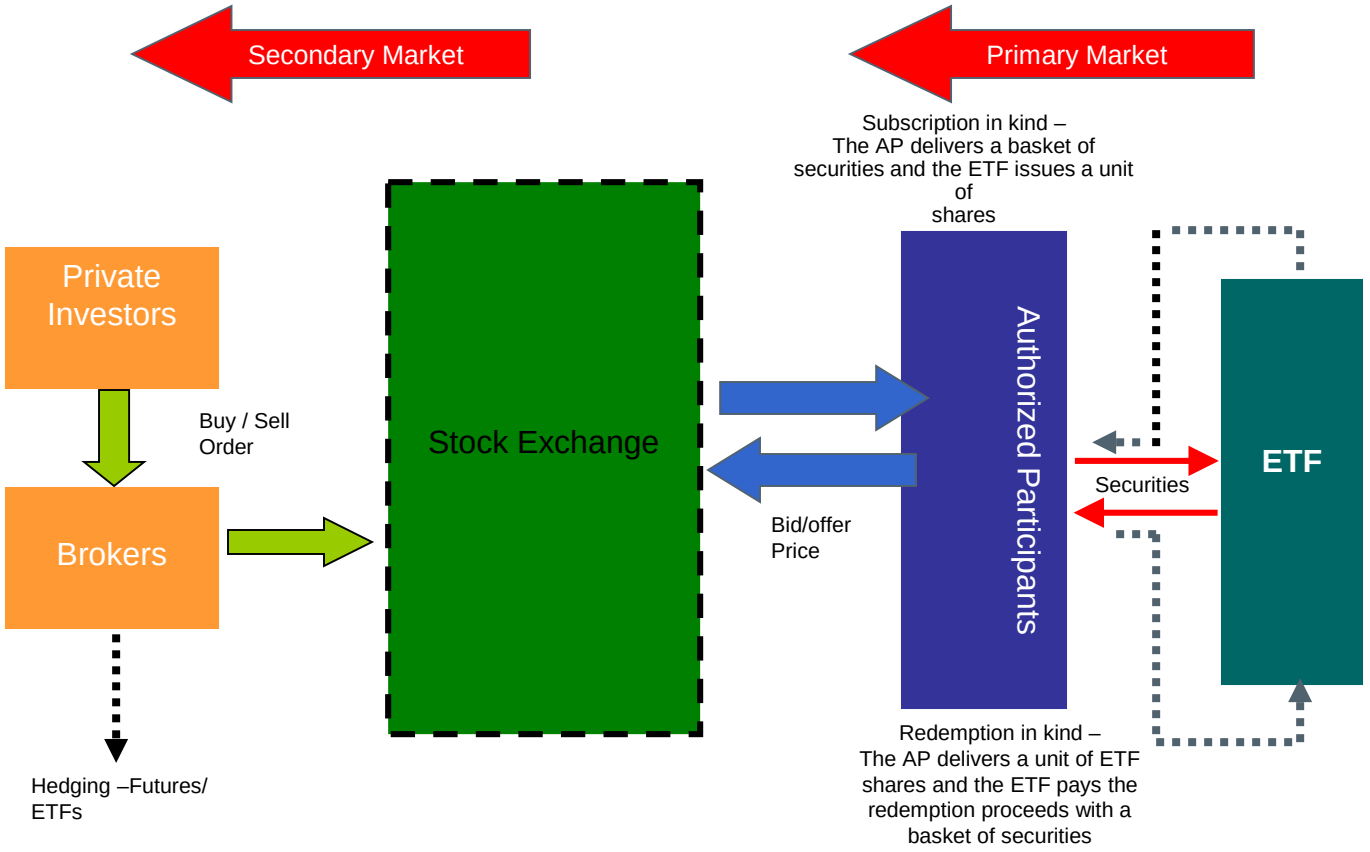
BACKGROUND

- Allow the “vast majority” of ETFs to operate without obtaining an SEC exemptive order
- Permitted to rely on the Rule:
  - Index-based ETFs
  - Fully transparent active ETFs
- Not permitted to rely on the Rule:
  - ETFs organized as UITs
  - Leveraged and inverse ETFs
  - Multi-class ETFs
  - Non-transparent active ETFs

OVERVIEW OF THE RULE

- "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
- No minimum creation unit size

OVERVIEW OF THE RULE



OVERVIEW OF THE RULE

- Condition #1: Each business day, an ETF must disclose certain information prominently on its website, which is publicly available and free of charge:

OVERVIEW OF THE RULE

- Condition #1: Each business day, an ETF must disclose certain information prominently on its website, which is publicly available and free of charge:
  - Before the opening of regular trading on the primary listing exchange, (i) each portfolio holding (including the ticker symbol, CUSIP or other identifier, description of holding, quantity of each security/asset, and percentage weight of the holding) that will form the basis for the next NAV calculation, and (ii) the cash balancing amount for a creation unit;

OVERVIEW OF THE RULE

- Condition #1: Each business day, an ETF must disclose certain information prominently on its website, which is publicly available and free of charge:
  - Before the opening of regular trading on the primary listing exchange, (i) each portfolio holding (including the ticker symbol, CUSIP or other identifier, description of holding, quantity of each security/asset, and percentage weight of the holding) that will form the basis for the next NAV calculation, and (ii) the cash balancing amount for a creation unit;
  - As of the close of the prior business day, the ETF's NAV, market price and premium/discount;

OVERVIEW OF THE RULE

- Condition #1: Each business day, an ETF must disclose certain information prominently on its website, which is publicly available and free of charge:
  - Before the opening of regular trading on the primary listing exchange, (i) each portfolio holding (including the ticker symbol, CUSIP or other identifier, description of holding, quantity of each security/asset, and percentage weight of the holding) that will form the basis for the next NAV calculation, and (ii) the cash balancing amount for a creation unit;
  - As of the close of the prior business day, the ETF's NAV, market price and premium/discount;
  - The ETF's median bid-ask spread during the last 30 calendar days (calculated as instructed);

OVERVIEW OF THE RULE

- Condition #1: Each business day, an ETF must disclose certain information prominently on its website, which is publicly available and free of charge:
  - Before the opening of regular trading on the primary listing exchange, (i) each portfolio holding (including the ticker symbol, CUSIP or other identifier, description of holding, quantity of each security/asset, and percentage weight of the holding) that will form the basis for the next NAV calculation, and (ii) the cash balancing amount for a creation unit;
  - As of the close of the prior business day, the ETF's NAV, market price and premium/discount;
  - The ETF's median bid-ask spread during the last 30 calendar days (calculated as instructed);
  - A table showing the number of days that the ETF's shares traded at a premium or discount during the last calendar year and during the most recently completed calendar quarter(s); and

OVERVIEW OF THE RULE

- Condition #1: Each business day, an ETF must disclose certain information prominently on its website, which is publicly available and free of charge:
  - Before the opening of regular trading on the primary listing exchange, (i) each portfolio holding (including the ticker symbol, CUSIP or other identifier, description of holding, quantity of each security/asset, and percentage weight of the holding) that will form the basis for the next NAV calculation, and (ii) the cash balancing amount for a creation unit;
  - As of the close of the prior business day, the ETF's NAV, market price and premium/discount;
  - The ETF's median bid-ask spread during the last 30 calendar days (calculated as instructed);
  - A table showing the number of days that the ETF's shares traded at a premium or discount during the last calendar year and during the most recently completed calendar quarter(s); and
  - A line graph showing the ETF's premiums and discounts during the last calendar year and during the most recently completed calendar quarter(s); and, if the ETF's premium or discount has been greater than 2% for seven consecutive trading days, a discussion of the factors that caused it.

OVERVIEW OF THE RULE

- Condition #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.

OVERVIEW OF THE RULE

- Condition #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.

OVERVIEW OF THE RULE

- Condition #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.
  - If the ETF utilizes a "custom" basket, these written procedures must:

OVERVIEW OF THE RULE

- Condition #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.
  - If the ETF utilizes a “custom” basket, these written procedures must:
    - Set forth detailed parameters for the construction and acceptance of custom baskets that are in the best interests of the ETF and its shareholders, including the process for any revisions to, or derivations from, those parameters; and

OVERVIEW OF THE RULE

- Condition #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.
  - If the ETF utilizes a “custom” basket, these written procedures must:
    - Set forth detailed parameters for the construction and acceptance of custom baskets that are in the best interests of the ETF and its shareholders, including the process for any revisions to, or derivations from, those parameters; and
    - Specify the titles or roles of the employees of the ETF’s adviser who are required to review each custom basket for compliance with those parameters.

OVERVIEW OF THE RULE

- Condition #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.
  - If the ETF utilizes a “custom” basket, these written procedures must:
    - Set forth detailed parameters for the construction and acceptance of custom baskets that are in the best interests of the ETF and its shareholders, including the process for any revisions to, or derivations from, those parameters; and
    - Specify the titles or roles of the employees of the ETF’s adviser who are required to review each custom basket for compliance with those parameters.
- Rule includes recordkeeping requirement for all AP agreements and baskets

OVERVIEW OF THE RULE

- Condition #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 RULE

- Section 22(d) and Rule 22c-1
  - Section 22(d), among other things, prohibits investment companies, their principal underwriters, and dealers from selling a redeemable security to the public except at a current public offering price described in the prospectus.
  - Rule 22c-1 generally requires that a dealer selling, redeeming, or repurchasing a redeemable security to do so only at a price based on its NAV.
- 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

EXEMPTIONS GRANTED BY THE RULE

- Section 17(a)
  - Section 17(a) generally prohibits an affiliated person of a registered investment company, or an affiliated person of such person, from knowingly selling any security or other property to or purchasing any security from the company.
- 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.

EXEMPTIONS GRANTED BY THE RULE

- Section 22(e)
  - Section 22(e) generally prohibits a registered open-end management investment company from postponing the date of satisfaction of redemption requests for more than seven days after the tender of a security for redemption.
- Exemption permits delivery of foreign investments as soon as practicable but in no event later than 15 days after the 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 MADE BY THE RULE TO CURRENT 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

CHANGES MADE BY THE RULE TO CURRENT ETF REGULATORY SCHEME

- 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

BOARD INTEREST: BASKET POLICY

- ETF Rule levels the playing field with regard to custom baskets
  - Early ETF market entrants had custom basket relief. However, overtime, SEC required baskets generally to correspond pro rata to its portfolio holdings
    - Concerns about APs pressuring ETFs to include certain securities in the basket, such as forcing ETFs into accepting less liquid or less desirable securities in basket in exchange for ETF shares (dumping) or pressure ETFs into including desirable securities in exchange for ETF shares (cherry-picking)
  - Resulted in different tax treatment and (unfair) competitive (dis)advantages for certain ETFs

BOARD INTEREST: BASKET POLICY

- Basket policies and procedures must:
  - Set forth detailed parameters for the construction and acceptance of custom baskets that are in the best interest of the ETF and its shareholders, including the process for any revisions to, or deviations from, those parameters and
  - Specify the titles or roles of the employees of the ETF's investment adviser who are required to review each custom basket for compliance with those parameters
  - Require retention of records related to baskets

BOARD INTEREST: BASKET POLICY

- Policies and procedures must cover:
  - The methodology that the ETF will use to construct baskets
  - Circumstances when the ETF may use representative sampling and how the ETF will sample
  - How the ETF, if index-based, may reflect in its basket changes in the ETF's portfolio holdings as a result of rebalancings and reconstitutions of index

BOARD INTEREST: BASKET POLICY

- Effective policies and procedures should:
  - Provide specific parameters regarding the methodology and process that the ETF would use to construct or accept each basket
  - Describe the ETF's approach for testing compliance and assessing (including through back testing or other periodic reviews) whether the parameters continue to result in baskets that are in the best interests of the ETF and its shareholders
  - Include reasonable controls designed to prevent inappropriate differential treatment among APs

BOARD INTEREST: BASKET POLICY

- ETFs may tailor their custom basket policies and procedures to address
  - Different risks and requirements for different types of custom baskets
  - Differing considerations for custom baskets depending on the direction of the trade (create or redeem)
- SEC identifies adviser as in the best position to design and administer the policy and procedures and to establish the parameters

BOARD INTEREST: MONITORING THE EFFECTIVENESS OF THE ARBITRAGE MECHANISM VIA THE BID-ASK SPREAD

- What is the arbitrage mechanism?
- What is a premium-discount?
- What is a bid-ask spread?
- How is a premium-discount different from a bid-ask spread?
- Why does the Rule focus on bid-ask spreads?
- How wide of a bid-ask spread is “too wide”? And what is a board required to do if under such circumstances?

BOARD INTEREST: MONITORING THE EFFECTIVENESS OF THE ARBITRAGE MECHANISM VIA THE BID-ASK SPREAD

- Non-transparent active ETF applications include specific requirements about bid-ask spreads to facilitate the arbitrage mechanism:
  - For the first three years, the Board will promptly meet if, for 30 days or more in any quarter or 15 days in a row, the absolute difference between either the premium-discount exceeds 1.00% or 2.00% or the bid/ask spread exceeds 1.00% or 2.00%
  - When meeting, the Board will consider…

BOARD INTEREST: MONITORING THE EFFECTIVENESS OF THE ARBITRAGE MECHANISM VIA THE BID-ASK SPREAD

- When meeting, the Board will consider…
  - the continuing viability of the Fund,
  - whether shareholders are being harmed, and
  - what, if any, action would be appropriate to among other things, narrow the premium/discount or spread, as applicable
- The Board will then decide…

BOARD INTEREST: MONITORING THE EFFECTIVENESS OF THE ARBITRAGE MECHANISM VIA THE BID-ASK SPREAD

- The Board will then decide…
  - whether to take any action, which may include:
    - changing lead market makers,
    - listing the ETF on a different exchange,
    - changing the size of creations units,
    - changing the ETF's investment objective or strategy, and
    - liquidating the ETF

SEC RuleMaking and Guidance

SEC RULEMAKING AND GUIDANCE

- Fund of Funds Rule – Rule12d1-4 proposed December 2018
- Derivatives Rule – Rule 18f-4 proposed December 2015
- Expedited Exemptive Applications – Rule 0-5 proposed October 2019
- SEC Guidance Updates
- Sweep Exams

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 own more than 3% of another fund’s shares
  - Investing fund can’t invest more than 5% of its assets in another fund
  - Investing fund can’t invest more than 10% of its 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
  - 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

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 – 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

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

SWEEP EXAMS

- OCIE 2019 Announced Exam Priorities:
  - Retail Investors, Including Seniors (disclosure of fees, conflicts of interest, never-examined advisers, broker-dealers)
  - Compliance and Risks in Critical Market Infrastructure (clearing agencies/transfer agents/exchanges)
  - Digital Assets
  - Cybersecurity
  - Anti-Money Laundering
- Sweeps for Liquidity Rule Compliance; Custom Indexes

Alternative Products

The SEC's Board Outreach Initiative

SEC DIVISION OF INVESTMENT MANAGEMENT'S ("IM") BOARD OUTREACH INITIATIVE

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

IN PERSON BOARD VOTING

- SEC IDC No-Action Letter (Feb. 28. 2019)

- Staff would not recommend enforcement action if open-end fund boards do not adhere to certain of the in-person voting requirements of:

IN PERSON BOARD VOTING

- Section 15(c) of the Investment Company Act of 1940, as amended ("1940 Act") (regarding investment advisory and principal underwriter agreement approvals and renewals); and
- 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.
- The relief is part of the SEC Division of Investment Management's ("IM") Board Outreach Initiative, one purpose of which is to reexamine the regulatory burdens placed on mutual fund boards.

AFFILIATE TRANSACTION OVERSIGHT

- SEC IDC No-Action Letter (Oct. 12, 2018)

- Staff would not recommend enforcement action if open-end fund boards do not make certain finding required by several 1940 Act exemptive rules:

AFFILIATE TRANSACTION OVERSIGHT

- Rule 10f-3 under the 1940, which provides exemptive relief for securities purchased during an underwriting wherein an affiliated person is a member of the underwriting syndicate, subject to certain conditions;
- Rule 17a-7 under the 1940 Act, which provides exemptive relief for purchases and sales of securities between an investment company and certain affiliated persons, subject to certain conditions; and

AFFILIATE TRANSACTION OVERSIGHT

- Rule 17e-1 under the 1940 Act, which provides a safe harbor from Section 17(e)(2)(A) of the 1940 Act, which prohibits a broker from receiving a commission, fee or other remuneration from an affiliated fund in excess of the usual and customary broker's commission, subject to certain conditions.

AFFILIATE TRANSACTION OVERSIGHT

- Each of these rules requires that a fund board adopt procedures reasonably designed to comply with the rule, make and approve changes to those procedures as the board deems necessary, and determine no less than quarterly that all transactions for the preceding quarter were effected in compliance with those procedures.

AFFILIATE TRANSACTION 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.

AFFILIATE TRANSACTION 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.”

K&L GATES

VALUATION & BOARD RESPONSIBILITY

- ABA Request for Clarification (July 22, 2019)
- Valuation – Board Considerations

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 REQUEST

- 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 Investment Company Act of 1940 (“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 REQUEST – 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, and
- 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 REQUEST – 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, and
- no additional specific actions by the board are necessary for the board to fulfill its obligation to determine fair value

VALUATION: ABA REQUEST – 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 REQUEST – SEC PRIOR GUIDANCE

- Prior SEC or staff guidance 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.

THE IMPORTANCE OF VALUATION AND LIQUIDITY DETERMINATIONS

- Valuation matters continue to be a subject of regulatory scrutiny.
  - Valuation: The fundamental integrity of a fund's net asset value is anchored on an accurate, daily valuation of the fund's portfolio holdings. If a fund's portfolio is materially mispriced, the fund (and the premise of transparency that underlies every fund) may well be compromised.

REGULATORY FRAMEWORK

Section 2(a)(41) and Rule 2a-4 view valuation issues in terms of a simple dichotomy between market value and fair value.

- Securities "for which market quotations are readily available" are to be valued at "market value."
- All other securities are to be valued at "fair value as determined in good faith by the board of directors."
- The special responsibilities placed on fund boards for fair value determinations, appear to arise out of a kind of objective vs. subjective distinction:
  - The implicit notion is that market valuations are essentially objective, while fair valuations require more judgment (i.e., are more subjective) and thus require more direct board involvement.

"FAIR VALUE AS DETERMINED IN GOOD FAITH"

- Practical application of this legal requirement:
  - Most boards delegate day-to-day fair value decisions to the investment adviser and review those decisions quarterly, after the fact.
  - SEC guidance contemplates delegation and notes that boards "may appoint persons to assist them in the determination of value and to make the actual calculations."
  - SEC guidance also requires boards to "continuously review the appropriateness of the method used" in determining fair value.
  - In 2012, Doug Scheidt, 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).

"FAIR VALUE AS DETERMINED IN GOOD FAITH"

- "Good faith" standard:
  - The SEC has stated, "[n]o single standard for determining 'fair value…in good faith' can be laid down, since fair value depends upon the circumstances of each individual case"
  - According to the SEC, fair value is "the amount which the [fund] might reasonably expect to receive for [a security] upon [its] current sale."
  - The SEC Staff has stated that "the good faith requirement is a flexible concept that can accommodate many different considerations."
  - The Staff has also admonished, however, that boards must determine whether the fair valuation procedures they have adopted "are reasonably likely to result in the valuation of securities at prices which the funds could expect to receive upon their current sale."
  - A fund board generally would not be acting in good faith if, for example, the board knows or has reason to believe that its fair value determination does not reflect the amount that the fund might reasonably expect to receive for the security upon its current sale.

"FAIR VALUE AS DETERMINED IN GOOD FAITH"

When should securities be fair valued?

- When market quotations are not "readily available."
- SEC guidance reflects that fair valuation may also be appropriate when the available market quotations are not reliable.
- Market quotations may not be reliable if:
  - sales have been infrequent;
  - there is a thin market for the security; or
  - the validity of the market quotations appears questionable due to (among other things):
  - an unreliable source;
  - staleness;
  - significant post-quotation events.

SEC GUIDANCE ON MAKING FAIR VALUE DETERMINATIONS

- No single correct way.
- The touchstone is whether the fair value reflects a price that the fund can reasonably expect to receive for the securities in a current sale under current market conditions.
- Methodologies and factors that may be used include:
  - multiples of earnings;
  - discount from market of similar, freely traded securities;
  - for debt instruments, yield to maturity;
  - fundamental analytical data; and
  - combinations of the foregoing.

DELEGATION AND CONTROLS

- Despite the emphasis in the 1940 Act on the board's responsibility for fair valuation, delegation of day-to-day fair valuation determinations is both necessary and contemplated by SEC guidelines.
- For most funds, direct board determinations of valuations and "continuous" board review of day-to-day decisions is impractical.
- The appropriate role for the board is to act as the highest level of oversight in a multi-level system of supervision and controls.
- Effective controls are central to the discharge of the board's responsibilities.

DELEGATION AND CONTROLS (CONTINUED)

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.

DELEGATION AND CONTROLS (CONTINUED)

- 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.

DELEGATION AND CONTROLS (CONTINUED)

- 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.

K&L GATES