K&L GATES

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Industry Regulatory Developments

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AGENDA

- SEC’s Liquidity Rule Implementation
- SEC’s Electronic Delivery Rule
- SEC’s New ETF Rule
- SEC’s Evolving View on Index Providers and Proxy Voting
- SEC’s Affiliated Transaction Guidance
- SEC’s Enforcement Actions

SEC’s Liquidity Rule and Implementation

SEC RATIONALE

- Aims to reduce **liquidity risk**
  - **Liquidity risk**: The risk that a fund could not meet requests to redeem fund shares without significant dilution of remaining investors' interests in the fund
- Responds to significant increase in inflows into less liquid strategies, such as fixed income, emerging market debt, and alternative investments
- Responds to registered fund evolution towards a shorter settlement period for open-end fund redemptions
  - Combined with some registered funds holding more securities with longer settlement periods

WRITTEN LIQUIDITY RISK MANAGEMENT PROGRAM REQUIREMENTS

- Each fund must assess, manage, and periodically review (no less frequently than annually) its liquidity risk based on a number of designated factors

SCOPE OF RULE 22e-4 – THE LIQUIDITY RULE

- **Who**: Rule 22e-4 applies to open-end funds and open-end exchange traded funds ("ETFs")
  - Closed-end funds and money market funds are not covered by the Rule
- **What**: Covered funds must adopt a Board-approved Liquidity Risk Management Program that requires a Program Administrator* to:
  - Assess, manage, and review liquidity risk using prescribed factors
  - Classify portfolio investments into "buckets"
  - Determine highly liquid investment minimum ("HLIM")
- Disclose in annual or semi-annual report a brief discussion of the operation and effectiveness of the liquidity risk management program over past year
- Required SEC Reporting via Form N-PORT and Form N-LIQUID
- Recordkeeping requirements

*Program Administrator must also be approved by the Board and cannot be a Portfolio Manager

WRITTEN PROGRAM REQUIREMENTS: LIQUIDITY CLASSIFICATION "BUCKETS"

- **Highly Liquid**: Includes cash and investments convertible into cash in 3 business days or less
- **Moderately Liquid**: Convertible into cash in more than three calendar days but no more than seven calendar days
- **Less Liquid**: Sale in seven calendar days or less, but settlement reasonably expected in more than seven calendar days
- **Illiquid Investments**: Cannot be sold in seven calendar days or less without the sale or disposition significantly changing the market value of the investment

WRITTEN PROGRAM REQUIREMENTS: ESTABLISH A HIGHLY LIQUID INVESTMENT MINIMUM

- The “highly liquid” investment minimum uses the same definition as the first liquidity classification (convertible to cash in three or less business days)
- A fund must establish an HLIM, review it at least annually, and establish policies and procedures for responding to a shortfall (*e.g.*, a dip below the established minimum)
- If a fund experiences a shortfall, it may still purchase assets that are not highly liquid, provided the purchases are in accordance with the fund’s shortfall policies and procedures

WRITTEN PROGRAM REQUIREMENTS: 15% LIMIT ON ILLIQUID INVESTMENTS

- Acquire test: No fund may purchase an illiquid investment if, immediately after the acquisition, more than 15% of its net assets would be illiquid investments
- Exceeding the 15% limit on a fund's **holdings** of illiquid assets triggers SEC and board reporting obligations
  - SEC report within one business day on Form N-LIQUID (not public)
  - Board report within one business day (with plan to address)
  - Board has additional responsibilities if a fund's illiquid investments remain above the 15% limit for more than 30 consecutive days (and each 30-day period thereafter)

OPERATIONAL AND COMPLIANCE MATTERS

- John Hancock Liquidity Rule Preparations
  - Rule creates new categories of securities assessment
    - Liquidity analysis and categorization of securities complex-wide
    - Highly Liquid Investment Minimum
  - Manager of Managers Complexity
    - Adviser program administration
    - Subadviser liquidity data
- LRMP Implementation
  - Board Approval of Written Program - June 1, 2019
  - First LRMP Annual Report to Board – June 1, 2020

BOARD RESPONSIBILITIES

- A fund's board (including a majority of independent directors) must:
  - Initially approve the written liquidity risk management program
  - Designate the investment adviser, officer, or officers ("program administrator") responsible for administrating the liquidity risk management program
  - Review a written report (at least annually) on the adequacy and effectiveness of the program and its implementation
  - Receive reports if a fund experiences a shortfall in its liquidity minimum or breaches the 15% limit on illiquid investments
- A fund's board is not required to:
  - Approve the highly liquid investment minimum (unless the fund is below its minimum and seeks to change it)
  - Determine whether a specific security is liquid or illiquid

RULE 22e-4 COMPLIANCE DATES

Element	Compliance Date**
Assessment, Management, and Periodic Review of Liquidity Risk as part of Liquidity Risk Management Program*	December 1, 2018
Formalize 15% Limit on Illiquid Assets*	December 1, 2018
Adopting polices and procedures for in-kind redemptions*	December 1, 2018
Board Designation of Program Administrator*	December 1, 2018
Non-public Classification of Portfolio Investments into Buckets*	June 1, 2019
Establish Highly Liquid Investment Minimum (HLIM)*	June 1, 2019
Board Approval of Liquidity Risk Management Program*	June 1, 2019
Annual Board Review of the Program*	June 1, 2019
N-PORT and N-LIQUID reports	June 1, 2019
Disclose operation and effectiveness of the liquidity risk management program in shareholder report	December 1, 2019

*The compliance dates for the related recordkeeping requirements coincide with the Element's compliance date.
**The compliance dates reflected are based on the fund complex's current assets under management ("AUM"). Fund complexes with AUMs under $1 billion have a built-in extension of six-months compared to those with over $1 billion in assets.

SEC’s Electronic Delivery Rule 30e-3

RULE 30e-3: OVERVIEW

- Final Rule adopted June 4, 2018
- Permits internet-based delivery of fund shareholder reports
  - “Notice and access” delivery similar to that used in proxy context
- Earliest use is January 2021 (subject to interim notice requirements)

EFFECTIVE DATES AND ROLLOUT

January 1, 2019	Effective date of the Rule/ investor preference tracking
January 1, 2019 - December 31, 2021 (“Compliance Period”)	Cover page disclosures
January 1, 2021	The earliest date that notices may be transmitted to investors in lieu of paper reports
January 1, 2022	Cover page and related disclosures no longer required

CONDITIONS FOR RELIANCE

- Materials available on a public website
- Provide annual paper notice of website access
  - In plain English
  - Directions to the website
  - A prominent legend in bold-face type stating that an important report to investors is available online
  - Include instructions for requesting a paper copy
- Investor opt-out
  - At any time, investors may opt for and receive mailed copies

EXTENDED TRANSITION PERIOD

- Two year transition period required
  - Notices may be delivered instead of full reports on January 1, 2021, at the earliest
- To do so, funds must begin tracking investor preferences for paper/ electronic delivery by January 1, 2019
- Previous Approval
  - Rule 30e-3 will not impact arrangements where investors have previously opted-in for e-delivery

PORTFOLIO HOLDINGS

- Complete quarterly portfolio holdings for the last fiscal year must be available on a publicly accessible website
  - Not required for money market funds under this Rule
    - But required to be available for the last 6 months under Rule 2a-7(h)(10)

NYSE RULE AMENDED

- The SEC simultaneously approved amendments to rules of the New York Stock Exchange regarding processing fees paid for the delivery of shareholder reports and notices
  - The amendments clarify and limit when “notice and access” processing fees may be charged
    - The SEC has requested comments on processing fees

SEC REVIEW

- Along with the Rule, the SEC published two releases seeking public comment
  - Retail Investor Experience
    - Seeking comment as to ways in which fund disclosure could be improved, including the manner of delivery
  - Intermediary Processing Fees
    - Seeking comment on the appropriateness and treatment of various fees such as “interim report fees,” “preference management fees,” and “notice and access fees”

NOTICE: ADDITIONAL PERMITTED INFORMATION

- Graphics and logos are permitted (if not misleading)
- SEC examples of supplemental permitted information
  - Top holdings
  - Performance information
  - Type of fund
  - Investment objectives/ strategies
  - Expense ratio/ example
  - PM information

NOTICES

- Must be filed with N-CSR when it contains supplemental information
  - Subsequent notices are not filed
  - Notices without supplemental information are not filed
- May permit negative consent for e-delivery at the fund complex or intermediary level

COVER PAGE DISCLOSURES

- To rely on Rule 30e-3 on January 1, 2021, the cover page of summary prospectuses, annual, and semi-annual reports:
  - Must include the legend, including the website where information is available, that is required in the notice
  - May include opt-in instructions for e-delivery of prospectus and other documents
- Cover page disclosures are no longer needed January 1, 2022

INTERMEDIARIES

- Can do consolidated notice delivery
- Investors can opt-in at the account level
  - Mirrors current opt-in for broker-dealers

WEB HOSTING

- The publically available website may be hosted by:
  - The fund
  - The broker-dealer
  - An intermediary
  - A third-party

TRIAL CONCEPT

- Only shareholder reports are included in Rule 30e-3
  - This is to test the proof of concept
  - More to come in the future (hopefully)

SEC’s New ETF Rule

"LEVELING" THE PLAYING FIELD?

- Rescission of orders
  - Rule would rescind orders of ETFs that "would be permitted to rely" on the rule
  - Rule would rescind master-feeder relief
    - Rationale has implications for multi-class ETF structure
- T-1 orders would be disallowed under the rule
  - SEC misunderstands the effect of T-1 on arbitrage
  - SEC believes that T-1 effectively allows for the operation of non-transparent active ETFs
  - Rule does not address payment of "slippage"

"LEVELING" THE PLAYING FIELD? (CONT.)

- Custom baskets
  - SEC seeks to provide balanced guidance in the release regarding the custom basket process
- Leveraged indexes
  - The proposed rule would allow for fluctuating leverage to be embedded in an ETF's index
  - SEC policy concern is compounding
- 12(d)(1) relief
  - The absence of 12(d)(1) relief in the proposed rule will automatically result in an unlevel playing field

N-1A AMENDMENTS

- New bid-ask spread disclosure
  - Multiple Q&As in summary prospectus
    - Extensive data will be required
    - ETFs may need a bid-ask service provider
  - Interactive calculator
    - ETFs will be required to provide an interactive calculator on their websites; costs are considerable
  - SEC Staff is “not married” to the proposed disclosure
    - SEC policy concern is investor comparisons of ETFs to mutual funds
    - Will likely accept qualitative disclosure with “some” numbers-based disclosure

N-1A AMENDMENTS (CONT.)

- Premium-discount disclosure
  - The definition of "**market price**" in the rule may lead to misleading premium-discount disclosure, particularly for thinly traded ETFs
    - **Market price**: The midpoint of the NBBO at the time that the ETF calculates NAV or the ETF's last traded price
    - Rule text is unclear whether an ETF is permitted, or *required*, to use the midpoint of the NBBO when it is more accurate

UPDATING THE 1934 ACT RELIEF

- ETFs issue “redeemable securities”
- No minimum size for creation units
- No composition requirements for baskets
- No IIV requirement
  - SEC sincerely questions whether the IIV should be improved rather than discarded
- No firewall requirement for affiliated index providers

SEC’s Evolving View on Index Providers and Proxy Voting

REGULATION OF INDEX PROVIDERS

- Dalia Blass signaled the SEC's Division of Investment Management review of index providers in 2018 ICI keynote address
  - Focus on "narrow" and "bespoke" indices developed for or used by only one client
  - The *Lowe* test for the publisher's exception
  - Revisiting the status of certain index provider types as investment advisers

REGULATION OF PROXY VOTING

- SEC rescinded the no action letters issued in 2004 to Institutional Shareholder Services, Inc. and Egan-Jones Proxy Services
- SEC roundtable November 15, 2018 to discuss:
  - The proxy voting and solicitation process
    - Universal proxy ballots
    - End-to-end vote confirmation and technologies (*e.g.*, blockchain)
  - The shareholder proposal process
  - The role and regulation of proxy advisory firms

SEC’s Affiliated Transaction Guidance

RECENT IDC SEC NO-ACTION LETTER

- Issued to Independent Directors Council on October 12, 2018
- Under Investment Company Act, Rules 10f-3, 17a-7, and 17e-1 are "affiliated transaction rules" and are Exemptive Rules for mutual funds.
- In order to perform these affiliated transactions a fund's board must:
  - Adopt procedures (and approve any necessary changes to the procedures) that are reasonably designed to provide that the transactions comply with the conditions of the Exemptive Rule; ***and***
  - Determine no less frequently than quarterly that all transactions made pursuant to the Exemptive Rule for the preceding quarter were effected in compliance with such procedures.
- SEC determined that the Board should be able to accept a simple written representation from the fund's Chief Compliance Officer ("CCO") stating that all transactions effected during the preceding quarter were in compliance with the procedures adopted by the board in accordance with the relevant Exemptive Rule.

SEC Enforcement Actions

RECENT SEC ENFORCEMENT ACTIONS

- **Transamerica**
  - **Aegon USA Investment Management, LLC, Transamerica Asset Management, Inc. et al., Advisers Act Rel. No. 4996 (Aug. 14, 2018)**
  - Four Transamerica entities charged by the SEC for selling investments that were supposedly based on quantitative models, but the models did not work as intended
  - Transamerica was cited for disclosure failures in various prospectuses and 15(c) Board reviews
  - The settlement includes a $36.3 million civil fine plus $61.3 million of disgorged sums and interests for investor recoupment

RECENT SEC ENFORCEMENT ACTIONS (CONT.)

- **Putnam**
  - **Putnam Investment Management LLC and Zachary Harrison, Advisers Act. Rel. No. 5050 (Sept. 27. 2018)**
  - SEC alleged the investment adviser and one of its portfolio managers facilitated dozens of prearranged cross-trades between advisory client accounts in a manner that disadvantaged some of the adviser's clients
  - Putnam will reimburse approximately $1,095,000 to its affected clients and pay a $1 million penalty
  - The portfolio manager will pay a $50,000 penalty and is suspended from the securities industry for 9 months

RECENT SEC ENFORCEMENT ACTIONS (CONT.)

- **Voya**
  - **Voya Financial Advisors, Inc., Advisers Act. Rel. No. 5048 (Sept. 26, 2018)**
  - Six-Day cyber-attack resulted in compromising of investor personal information
  - Alleged violation of "Safeguards Rule" of Regulation S-P (Rule 30(a))
  - First enforcement action under "Identity Theft Red Flags Rule" of Regulation S-ID (Rule 201)
  - Rule requires BDs/Advisers to create and implement programs to detect, prevent and mitigate identity theft
  - $1 million fine assessed

RECENT SEC ENFORCEMENT ACTIONS (CONT.)

- **Merrill**
  - **Merrill Lynch, Pierce, Fenner & Smith Incorporated, Advisers Act. Rel. No. 4989 (Aug. 20, 2018)**
  - Alleged failure to disclose conflicts of interest arising from its own business interests in deciding whether to continue offering products managed by a third-party adviser
  - ML did not disclose conflict in handling 3rd party products managed by US subsidiary of a foreign multinational bank
    - More than 1,500 ML retail advisory accounts had invested $575 million in products
    - ML put hold in steering investments to products pending discussions with third-party bank
  - $8.9 million fine assessed

RECENT SEC ENFORCEMENT ACTIONS (CONT.)

- **MFS**
  - **Massachusetts Financial Services Company, Advisers Act. Rel. No. 4999 (Aug. 31, 2018)**
  - Alleged misleading statements in advertisements
  - MFS portrayed its quantitative "blended research" model approach as selecting stocks having superior returns to those selected by other methods
  - MFS failed to disclose back-testing and hypothetical quantitative stock ratings in the models
  - $1.9 million fine assessed

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