Morgan Lewis

REGISTERED FUNDS TRENDS AND DEVELOPMENTS

Quarter in Review Series

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- **Proposed Rules Regarding Funds’ Use of Derivatives**
  - **Rule 18f-4**
    - **Derivatives Transactions:** Proposed Rule 18f-4 under the Investment Company Act of 1940 (the 1940 Act), is a re-proposal of a 2015 proposed rule. To rely on Rule 18f-4, with respect to a fund’s derivatives transactions, the fund would be required to meet the following conditions:
      - ***Derivatives Risk Management Program***. A fund would be required to adopt and implement a written derivatives risk management program that includes the following elements:
        - Risk identification and assessment.
        - Derivatives risk guidelines.
        - Stress testing.
        - Backtesting - Calculation and compliance with limits on a fund’s “value-at-risk” (VaR).
        - Internal reporting.
        - Escalation of material risks to persons responsible for portfolio management of the fund and to the Fund’s board as appropriate.
        - Periodic review of the program at least annually.

- ***Board Oversight and Reporting***.
  - Approval of Derivatives Risk Manager - A fund's board (including a majority of its independent trustees) would be required to approve the designation of a Derivatives Risk Manager, but would *not* be required to approve the Program itself.
    - The Derivatives Risk Manager would be an officer or officers of the fund's investment adviser but could not be a portfolio manager of the Fund; or if multiple officers serve as Derivatives Risk Manager, it could not have a majority composed of portfolio managers of the Fund, and would be required to have relevant experience regarding the management of derivatives risk.
  - Report on Program Implementation and Effectiveness by the Derivatives Risk Manager (on or before implementation of the program and at least annually thereafter).
  - Regular Board Reporting – At a frequency determined by the Board, the Derivatives Risk Manager would be required to provide written reports regarding analysis of any exceedance of risk guidelines, results of stress testing, and results of backtesting since the last report to the Board.

Proposed Rules Regarding Funds' Use of Derivatives

- ***Limit on Leverage Risk***. The VaR of a fund's portfolio would not be permitted to exceed 150% of the Fund's designated reference index, or, if the Derivatives Risk Manager is unable to identify a designated reference index that is appropriate for a fund, the fund's VaR would not be permitted to exceed 15% of the value of the Fund's net assets.
  - A Fund would be required to determine its compliance with the applicable VaR test at least once on each business day.
  - If a fund determines that it is not in compliance, it must become compliant within three business days after such termination or it becomes subject to additional requirements, including:
    - The Derivatives Risk Manager would be required to report to the fund's board and explain how and by when the Derivatives Risk Manager reasonably expects that the fund will restore compliance;
    - The Derivatives Risk Manager would be required to analyze the circumstances that caused the fund to be out of compliance for more than three business days and update any program elements as appropriate to address those circumstances; and
    - The fund would not be permitted to enter into any derivatives transactions (other than derivatives transactions designed to reduce the fund's VaR) until the fund has been back in compliance with the applicable VaR test for three consecutive business days and has satisfied the board reporting requirement and Program analysis and updated program elements as appropriate.

- ***Exception for Limited Derivatives Users***. The proposed rule provides an exception for the limit on leverage risk or the adoption of a risk management program if the Fund adopts and implements policies and procedures reasonably designed to manage the fund's derivatives risks and
  - (i) the fund's derivatives exposure does not exceed 10% of the Fund's net assets; or
  - (ii) the fund limits its use of derivatives transactions to currency derivatives that hedge the currency risks associated with specific foreign-currency-denominated equity or fixed-income investments held by the fund, provided that the notional amounts of such derivatives do not exceed the value of the hedged instruments denominated in the foreign currency (or the par value thereof in the case of fixed-income investments) by more than a negligible amount.

- **Special Rules for Leveraged/Inverse Funds.**
  - **Alternative Requirements:** Special carve out for leveraged/inverse funds whereby they would not have to comply with the proposed VaR-based leverage risk limit provided a Fund limits the investment results it seeks to 300% of the return (or inverse return) of its underlying index and discloses in its prospectus that it is not subject to proposed Rule 18f-4's limits on leverage risk.
  - **Sales Practices Rules:** Two new sales practices rules would generally prohibit a broker-dealer or investment adviser from accepting an order from a retail investor to buy or sell a leveraged/inverse investment vehicle unless the firm has approved the retail investor's account to engage in those transactions.
- **Reverse Repurchase Agreements and Similar Financing Transactions:** Proposed rule includes requirement to combine reverse repurchase transactions with bank borrowings (and similar transactions) for purposes of calculating asset coverage under Section 18.
- **Unfunded Commitment Agreements:** Rule 18f-4 would permit a fund to enter into an unfunded commitment agreement if the fund reasonably believes, at the time it enters into such agreement, that it will have sufficient cash and cash equivalents to meet its obligations with respect to all of its unfunded commitment agreements, in each case as they come due.

Proposed Rules Regarding Funds’ Use of Derivatives

- **Corresponding Changes to ETF Rule:** Rule 6c-11 under the 1940 Act that permits ETFs that satisfy certain conditions to operate without obtaining exemptive orders would be amended to remove the exclusion of leveraged/inverse ETFs.
- **Adjustments to Existing Reporting Requirements:** Form N-LIQUID would be renamed Form N-RN and amended to require funds to confidentially report information about VaR test breaches that last longer than three business days. Form N-PORT would be amended to include new reporting items regarding Funds’ derivatives exposures and VaR tests. Form N-CEN would be amended to require a fund to identify whether it relies on Rule 18f-4 and whether it is a limited derivatives user or leveraged/inverse investment vehicle, or enters into any reverse repurchase agreements, or similar financing transactions, or any unfunded commitment agreements.
- **Existing SEC and Staff Guidance:** As proposed, current asset segregation requirements would be eliminated and Release 10666 and related Staff guidance would be rescinded.

Four Semi-Transparent Actively Managed ETF Models Approved

- **SEC Exemptive Orders Issued (Blue Tractor Group, Natixis/NYSE, Fidelity, and T. Rowe Price):**
- The semi-transparent models, each having its own arbitrage mechanism designed to keep a semi-transparent ETF's secondary market price at or close to the semi-transparent ETF's per-share NAV, differ from the Precidian non-transparent actively managed ETF model approved by the SEC last May because, among other things, the semi-transparent models provide for certain daily portfolio transparency.
- Like the Precidian model, however, each of the semi-transparent models permits a semi-transparent ETF to invest only in certain securities that trade on a US exchange contemporaneously with the semi-transparent ETF, and cash and cash equivalents, and prohibits a semi-transparent ETF from borrowing for investment purposes, holding short positions, or purchasing any security that is illiquid at the time of purchase.

Proposed Amendments to Proxy Rules

- **SEC Amendments Approved:** On November 5, the SEC voted to propose two new proxy rules.
  - **Proxy Advice Proposal**
    - Proposed Amendments to Rule 14a-2(b) would condition exemption from the information and filing requirements of the proxy rules with respect to proxy voting advice businesses on:
      - Specified disclosures about whether their proxy voting advice contains any potential conflicts of interest.
      - Giving companies (and certain other soliciting persons) an opportunity to review and provide feedback on proxy voting advice *before* it is issued to clients (with length of the review period dependent on the number of days between the filing of the definitive proxy statement and the date of the shareholder meeting as set forth below)
        - no less than five business days before issuance, if the company has filed its definitive proxy statement at least 45 calendar days before the meeting date; and
        - no less than three business days before issuance, if the company has filed its definitive proxy statement less than 45 calendar days, but at least 25 calendar days, before the meeting date.

  - Providing companies a second and final notice of voting advice (no earlier than the applicable review period and no later than two business days prior to delivery to clients). This final notice must include a copy of the proxy voting advice that will be delivered to clients, including any revisions made after the review and feedback period.
  - Including in its proxy voting advice a hyperlink or analogous electronic medium that leads to the company's or other soliciting person's, as applicable, statement regarding the proxy voting advice.
- Proposed Amendments to Rule 14a-9 would require proxy advisory businesses to disclose information about how they form recommendations, such as their sources of information and what research methodologies they used in their analysis.
- The proposal would codify recent SEC guidance by amending the definition of "solicitation" in Rule 14a1(l) under the Exchange Act to generally include proxy voting advice, other than proxy voting advice furnished in response to an unprompted request.

Proposed Amendments to Proxy Rules

- **Proposed Amendments to the Shareholder Proposal Rule (Rule 14a-8)**
  - Change to Ownership Thresholds
    - Currently, to submit a proxy proposal, a shareholder must continuously hold at least $2,000 in market value (or one percent) of a company's stock entitled to vote for at least one year.
    - The proposed changes would permit a shareholder to submit a proposal if the shareholder has continuously held at least: (i) $2,000 of the company's securities for at least three years; (ii) $15,000 of the company's securities for at least two years; or (iii) $25,000 of the company's securities for at least one year.
  - Change to Resubmission Thresholds
    - Currently, a company may exclude a shareholder proposal to resubmit the same (or a similar) proposal that has been submitted during the preceding 5 calendar years if the prior proposal did not receive at least 3, 6, and 10 percent shareholder approval for the first, second, and third submissions, respectively.
    - The proposal would raise those resubmission thresholds to 5, 15, and 25 percent, respectively, of "votes cast," making it more difficult for shareholders to resubmit rejected proposals.
  - New Momentum Exclusion
    - Would allow companies to exclude a proposal that previously had been voted on three or more times in the last five years, notwithstanding having received at least 25 percent of the votes cast on its most recent submission, if at the time of the most recent vote the proposal: (i) received less than 50 percent of the votes cast; and (ii) experienced a decline in shareholder support of 10 percent or more compared to the immediately preceding vote.

- **Industry Feedback**
  - Comments were due on February 3.
  - Many asset managers and other industry participants (e.g., ICI, Morningstar) have pushed back on some or all of the proposed rules, arguing that the rules as proposed may:
    - Make an already tight and difficult time frame even more complicated
    - Inadvertently increase fund fees
    - Expose confidential and proprietary information provided to proxy advisory firms
    - Compromise advice
    - Hinder fund shops' abilities to delivery services to their clients
    - Prevent "meritorious and important shareholder resolutions" from getting on the ballot
    - Eliminate resolutions that gain huge increases in support following a news event

- **MetWest:** U.S. District Court for the Central District of California awarded MetWest over $400,000 in costs that the firm incurred in preparing for and during the trial of a Section 36(b) excessive fee case in which the plaintiff claimed that MetWest charged excessive advisory fees to its Total Return Bond Fund because the advisory fees were higher than the fees that MetWest charged for providing substantially the same services as a sub-adviser to third-party funds.
- **Great-West:** U.S. District Court for the District of Colorado judge ruled in December that she would watch portions of a videotaped deposition of a former Great-West funds independent director in connection with the trial of a Section 36(b) excessive fee case in which the plaintiffs allege that Great-West charged excessive advisory and administrative fees to certain of its funds because Great-West retained a disproportionate amount of the fees while sub-advisers did most of the work.
  - According to plaintiffs' complaint, video shows the director admitting she doesn't know what 12b-1 fees are, and that she believed that Great-West funds' shareholders were investors in the funds' advisor rather than the funds.
  - Complaint includes heavy focus on index funds. Plaintiffs note that competitor index funds charged substantially less and had better performance.
  - Here, plaintiffs are attempting to show that fund board wasn't independent or conscientious in approving fees.
  - Case was filed by same firm (Schlichter, Bogard & Denton) that has reportedly reached over $460 million in settlements in a separate group of cases over 401(k) fees.
  - Trial began in mid-January.

Enforcement and Compliance

- **Examinations of Investment Companies:** SEC's Office of Compliance Inspections and Examinations ("OCIE") issued a Risk Alert that includes information on the most often cited deficiencies and weaknesses that OCIE has observed in recent examinations of:
  - **Investment Companies**
    - **Fund Compliance Rule (Rule 38a-1 under the 1940 Act)**
      - Compliance programs did not take into account the nature of the funds' business activities.
      - Policies and procedures were not followed or enforced.
      - Inadequate service provider oversight.
      - Annual reviews were not performed or did not address the adequacy of the funds' policies and procedures.
    - **Disclosure to Investors**
      - Incomplete or potentially materially misleading information provided in prospectuses, statements of additional information, or shareholder reports when compared to funds' actual activities.

Enforcement and Compliance

- **Section 15(c) Process**
  - Reasonably necessary information not requested or considered.
  - Inadequate discussion forming the basis of board approval.
- **Fund Code of Ethics Rule**
  - Failure to implement code of ethics or procedures reasonably necessary to prevent code of ethics violations.
  - Failure to follow or enforce code of ethics.
  - Code of ethics approval and reporting.

- **<u>Money Market Funds</u>**
  - **"Eligible Securities" and Minimal Credit Risk Determinations**
    - Failure to include in their credit files one or more of the factors required to be considered when determining whether a security presents minimal credit risks and is an eligible security.
    - Inadequate documentation of periodic updating of their credit files to support the eligible security determination.
    - Failure to maintain records that adequately support their determination that investments in repurchase agreements with non-government entities were fully collateralized by cash or government securities (for government MMFs).

Enforcement and Compliance

- **Summary of Significant Stress Testing Assumptions**
  - Failure to include the required summary of significant assumptions used in the stress tests.
- **Policies and Procedures**
  - Failure to adopt and implement compliance policies and procedures reasonably designed to address certain requirements under Rule 2a-7 and other areas.
- **Website and Advertising Materials**
  - Failure to post on their website all information required under Rule 2a-7 and/or posted inaccurate information on their websites.

– **Target Date Funds**

- Incomplete and potentially misleading disclosures in prospectuses and advertisements.
- Incomplete or missing policies and procedures.

SEC Issues Notice of Application Requesting Relief from In-Person Meeting Requirement for Approval or Amendment of Sub-Advisory Agreements

- Blackstone's application set forth the following conditions:
  - The Independent Trustees will approve a change in sub-adviser, as well as any material amendment to an existing sub-advisory agreement, at a non-in-person meeting where the Trustees participate by a means of communication that allows them to hear each other simultaneously.
  - Management will represent to the Board that the materials provided for the non-in-person meeting include the same information that the Board would have received if the approval of the requested sub-advisory change occurred at an in-person meeting.
  - Notice of the non-in-person meeting will explain the need for considering the proposed sub-advisory change at a non-in-person meeting. Once notice of the meeting has been sent, the Trustees will have the opportunity to object to considering the proposed sub-advisory change at a non-in-person meeting. If a Trustee objects, the Board will consider the change at an in-person meeting, unless the objection is rescinded.
  - Any sub-advised fund that would rely on this exemptive relief will disclose the relief in its registration statement.
- If a hearing is not requested by February 18th, an order will be issued granting the application.

- If an order is granted, the SEC will permit the Blackstone funds to rely on this exemptive relief without seeking shareholder approval.
  - Investment advisers and trusts that would also like to rely on this exemptive relief, and already have a manager of managers order in place, could file an application similar to the Blackstone application.
  - For those investment advisers and trusts that do not currently have a manager of managers order, but would like one and would also like to rely on the in-person meeting requirement relief, a single application could be filed requesting both forms of relief.
- If the order is granted as anticipated, it would be the latest indication of the willingness of the SEC and its staff to modernize the responsibilities of fund directors.

Proposed Amendments to Exemptive Application Procedures

- **SEC Proposed Rules**: On October 18, the SEC proposed amendments to exemptive application procedures that would:
  - Establish an expedited review procedure for exemptive applications under the 1940 Act that are substantially identical to recent precedent;
    - “Substantially identical” applications would be applications requesting relief from the same sections of the 1940 Act and the rules thereunder, containing identical terms and conditions, and differing only with respect to factual differences that are not material to the relief requested.
  - Establish an internal timeframe for review of applications that would not qualify for such expedited review;
    - Examples of applications that wouldn’t qualify include those seeking novel, largely unprecedented relief or relief for which some SEC precedent exists but that raise additional questions of fact, law or policy.
  - Deem applications withdrawn when applicants fail to timely respond to SEC staff comments; and
  - Begin public dissemination of SEC staff comments on applications, and responses to the comments.

Proposed Amendments to Auditor Independence Rule

- On December 30, the SEC issued for public comment its latest proposed amendments to its auditor independence rule (Rule 2-01 of Regulation S-X). The proposed amendments would:
  - (i) amend the definitions of “affiliate of the audit client” and “investment company complex” to add materiality qualifiers to “common control” provisions of such definitions;
  - (ii) shorten the look-back period for domestic first time filers from three years to one year;
  - (iii) add certain student loans and de minimis consumer loans to the categorical exclusions from independence impairing lending relationships;
  - (iv) replace the reference to “substantial stockholders” in the business relationship rule with the concept of beneficial owners with significant influence to align this rule with recent changes made to the Loan Rule; and
  - (v) replace the transition and grandfathering element of the rule with a framework to address inadvertent independence violations arising from merger and acquisition transactions.

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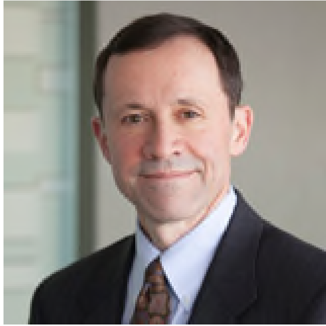

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Thomas S. Harman represents investment advisers (both publicly and privately held), mutual funds, closed-end funds, business development companies, and private investment funds. In so doing, he advises them on a variety of legal and compliance issues. Tom represents the board of directors of several fund families. He also advises issuers with respect to the availability of exemption from the Investment Company Act of 1940.

Tom previously served as chief counsel and then associate director (chief counsel) of the Securities and Exchange Commission's (SEC) Division of Investment Management.

A frequent speaker on investment management issues and the author of numerous articles on industry issues, Tom taught in the securities law program at the Georgetown University Law Center for more than a decade. He serves as co-planning chair of the Annual ALI-CLE Course on Investment Company Regulation and Compliance, and is on the Advisory Board of the ALI-CLE.

Based on feedback from clients, peers, and other industry professionals, *Chambers USA* has named Tom a leading US lawyer for investment management for the past eight years. *Chambers* noted that Tom is "a strong player" and that he is respected for "innovative and thoughtful work, coupled with encyclopedic knowledge."

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Laura E. Flores’ practice focuses on the regulation of investment companies and investment advisers. Laura regularly represents exchange-traded funds (ETFs), mutual funds, and variable insurance-dedicated products, as well as their sponsors and boards of directors, and investment advisers. She counsels both well-established clients and clients that are new to the industry on a variety of regulatory, transactional, compliance and operational issues, including the development of new financial products and services, federal and state registration issues, the preparation and implementation of compliance programs, business combinations involving investment companies and investment advisers, interpretive and “no-action” letter requests, requests for Securities and Exchange Commission exemptive relief, and regulatory examinations. Laura also counsels investment advisory clients on matters, including advertising and communications with the public, investment adviser registration, and separately managed account (or wrap fee) programs. Laura also has significant experience representing “liquid alt” funds, funds that invest through offshore subsidiaries, and funds that utilize QFII/RQFII quotas to invest directly in securities issued and traded in China.

Prior to joining Morgan Lewis, Laura was a partner in the financial services practice of another international law firm, where she also served on the firm’s diversity committee. Before that, Laura was assistant general counsel in the asset management division of a global bank and an associate in the Washington D.C. office of Morgan Lewis.

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Sean Graber advises companies in the securities industry on investment management matters. Investment advisers, mutual funds, closed-end funds, private investment companies, registered funds of hedge funds, and exchange-traded funds seek his advice on organizational issues, registration, and ongoing regulatory compliance matters. He also serves as counsel to the boards of directors of mutual funds, and he advises insurance companies on regulatory matters relating to variable insurance products.

Sean counsels clients on regulatory and transactional investment management matters. These include the development of new products and services, US federal and state registration and compliance issues, and US Securities and Exchange Commission (SEC) enforcement actions. He advises clients on mergers and acquisitions involving investment companies and investment advisers, and addresses interpretive and “no-action” letter requests, SEC exemptive orders, and related matters.

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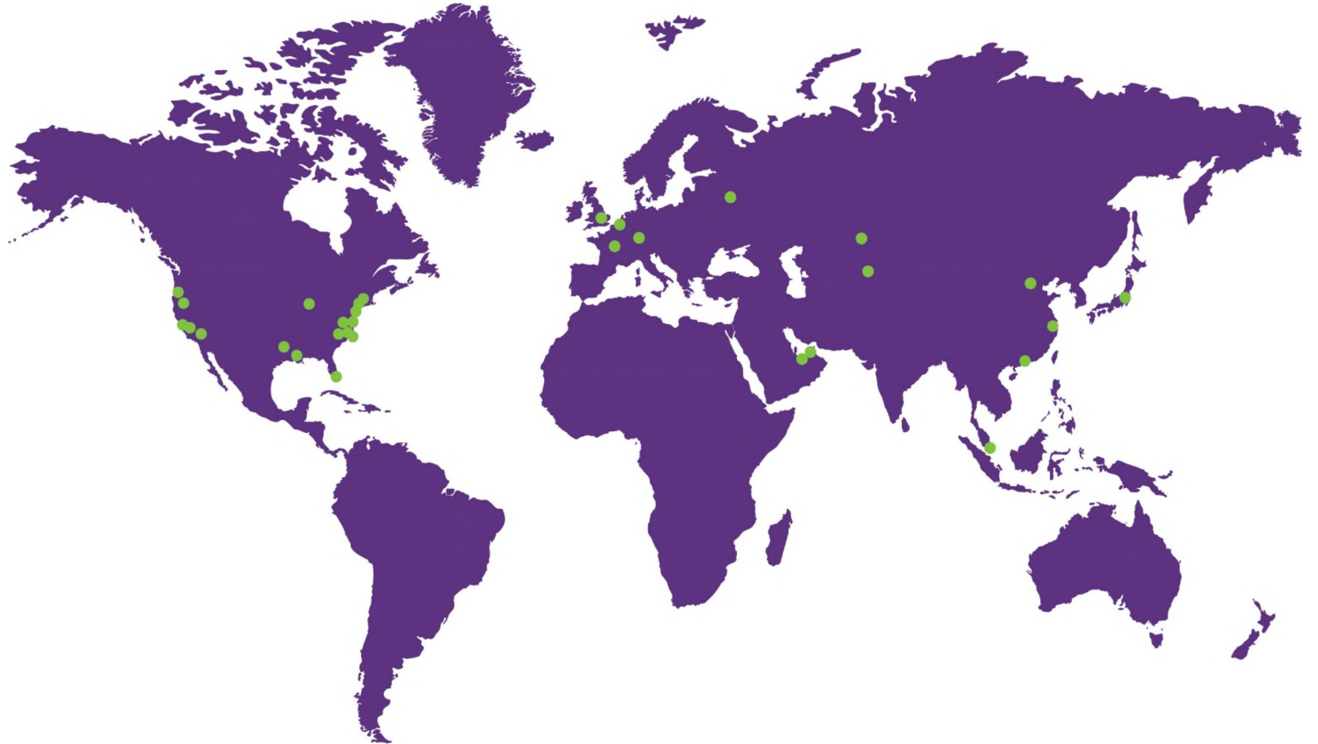

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