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REGS & EGGS

**RECENT DEVELOPMENTS IMPACTING
REGISTERED FUNDS AND THEIR
INVESTMENT ADVISERS**

March 20, 2023 | 7:00-8:00 am PT



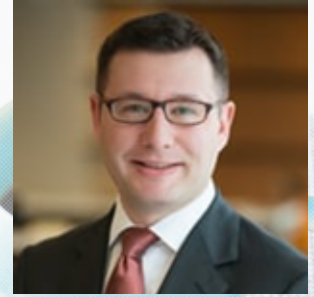
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Tailored Shareholder Reports

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Overview of Tailored Shareholder Report Rules

- **What?**

- In October 2022, the SEC adopted rule and form amendments related to (1) tailored shareholder reports, (2) Form N-CSR, (3) Rule 30e-3, and (4) fund advertisements

- **Why?**

- Rules meant to modernize shareholder reports to better serve the needs of retail investors
- Layered disclosure approach

- **Who?**

- Rules apply to all registered open-end funds (mutual funds and most ETFs)
- Registered closed-end funds and business development companies excluded

- **When?**

- **Compliance date is July 24, 2024**
- Compliance date is tied to delivery, not a fund's fiscal year end

Tailored Shareholder Reports: Format

- Reports meant to be “concise and visually engaging”
- Guidance re: electronic presentation/fund websites
- One report per fund and per class
 - Other class information required on fund websites
- iXBRL
- Limitation on content scope

Tailored Shareholder Reports: Content

- Cover page
- Fund expenses
- Management's Discussion of Fund Performance
 - Narrative: "briefly summarize" the "key factors" with graphics/text features
 - Performance: class-specific presentation, 10-year maximum, and comparison to "broad-based" index ("characteristic" indexes not included)
- Fund Statistics
 - Net assets, total portfolio holdings, portfolio turnover, and advisory fees paid
 - Additional statistics permitted AFTER required statistics
- Graphical representation of holdings
- Material fund changes
- Householding disclosures

Tailored Shareholder Reports: Delivery

- Amendments to Rule 30e-3
 - Open-end funds are now prohibited from relying on Rule 30e-3
 - Notice and access replaced by delivery of tailored shareholder reports
- New (and repeated) implementation costs

Availability of Additional Information

- Funds will need to continue to make available on a website (and deliver upon request) and file on Form N-CSR certain information currently contained in the existing long-form shareholder reports:
 - Financial statement
 - Financial highlights
 - Remuneration paid to directors, officers, and others
 - Change in and disagreement with accountants
 - Matters submitted to fund shareholder for a vote
 - Statement regarding the basis for the board's approval of the investment advisory contract
 - Complete portfolio holdings (1st and 3rd quarters)

Fund Advertisements

- Amendments apply to all investment companies subject to the SEC's advertising rules (including registered closed-end funds and BDCs)
- Prohibition on misleading statements about fees
 - Concerns regarding “zero fee” or “no expense” descriptions misleading investors
 - Requires contextual analysis of disclosure

What Was Left Out?

- Several components of the 2020 proposal were NOT included in the final rules:
 - Proposed Rule 498B
 - Proposed changes to prospectus fee disclosure
 - Proposed risk ordering/definition of “principal risk”
- May be revisited in the future...

Next Steps

1

Review content and format of shareholder reports (and other implicated filings, e.g., N-CSR and N-CEN)

2

Review electronic disclosure capabilities and website content

3

Assess broad-based securities market index identification

4

Implications of Rule 30e-3 changes

5

iXBRL implementation

6

Fund advertisement review

Investment Adviser Outsourcing Proposal

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Overview of the Proposed Rule

- Key Definitions
 - Service Providers
 - Covered Functions
- Rule Requirements
 - Due Diligence
 - Monitoring
- Additional Amendments

Problems Posed by the Proposed Rule

- ✓ Unnecessary
- ✓ Duplicative of other rules
- ✓ Definition of “Covered Function” is overbroad and vague
- ✓ Small advisers in particular would be harmed
- ✓ Major cybersecurity risks
- ✓ SEC has no jurisdiction over many service providers
- ✓ Antifraud is inappropriate

Proposed Cybersecurity Rules/Role of Fund Boards

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Overview of Proposed Cybersecurity Rules

Applicability

- Registered investment advisers
- Registered investment companies
- Closed-end funds that have elected to be treated as business development companies

Background

- Growing number of cybersecurity risks for advisers and funds
- No existing SEC rules requiring comprehensive cybersecurity risk management programs
- Clients and investors may not be receiving sufficient information on cybersecurity incidents

Proposal Elements

- Adopt and implement cybersecurity risk management policies and procedures
- Report significant cybersecurity incidents to the SEC
- Disclose information about cybersecurity risks and significant incidents
- Prepare and maintain related records
- Fund boards must initially approve policies and procedures and must exercise oversight including review of annual report

Comments

- Comment deadline (extended) was November 1, 2022
- Approximately 60 comment letters submitted, including ICI and IDC
- Comment period reopened in March 2023 (until 60 days after Federal Register publication)

Cybersecurity Risk Management Policies and Procedures

Proposed Rule 206(4)-9 and Proposed Rule 38a-2. Cybersecurity policies and procedures would be required to include the following elements:

- Periodic risk assessments
- User security and access
- Information protection, including oversight of third parties that receive, maintain, or process fund information, or are otherwise permitted to access fund information systems and any fund information residing therein
- Cybersecurity threat and vulnerability management
- Cybersecurity incident detection, response, and recovery

Annual Reviews and Written Reports

- At least annually, advisers and funds would be required to (1) review the effectiveness of their policies and procedures and (2) prepare a written report. Fund board must review annual report.

Reporting Cybersecurity Incidents to the SEC

Proposed Rule 204-6

- Advisers would be required to submit proposed Form ADV-C to the SEC promptly, but in no event more than 48 hours, after having a reasonable basis to conclude that a significant adviser cybersecurity incident or a significant fund cybersecurity incident had occurred or is occurring.
- Advisers would be required to amend any previously filed Form ADV-C within 48 hours:
 - (1) After information previously reported becomes materially inaccurate;
 - (2) If additional or new material information about a previously reported incident is discovered; or
 - (3) After resolving a previously reported incident or closing an internal investigation relating to a previously reported incident.

Reporting Cybersecurity Incidents to the SEC (cont.)

Proposed Form ADV-C

- Structured as a series of check-the-box and fill-in-the-blank questions.
- Captures, among other things, identifying information about the adviser, details about the nature and scope of the incident, whether law enforcement or other government agencies have been notified, and whether the incident is covered under a cybersecurity insurance policy.

Disclosure of Cybersecurity Risks and Incidents

Amended Form ADV

- Proposed Item 20 of Form ADV Part 2A would require advisers to describe:
 - (1) Any cybersecurity risks that could materially affect the advisory services they offer and how they assess, prioritize, and address cybersecurity risks; and
 - (2) Any cybersecurity incidents that have occurred in the last two fiscal years that have significantly disrupted or degraded the adviser's ability to maintain critical operations, or have led to the unauthorized access or use of adviser information, resulting in substantial harm to the adviser or its clients.
- Proposed Rule 204-3(b) would require an adviser to promptly deliver interim brochure amendments to existing clients if the adviser adds disclosure of a cybersecurity incident to its brochure or materially revises information already disclosed in its brochure about such an incident.

Disclosure of Cybersecurity Risks and Incidents (cont.)

Amended Fund Registration Statements

- The proposal would also require funds to disclose, in their registration statements, any significant fund cybersecurity incidents that have occurred in the last two fiscal years.
- Disclosure must include (1) the entity or entities affected; (2) when the incident was discovered and whether it is ongoing; (3) whether any data was stolen, altered, or accessed or used for any other unauthorized purpose; (4) the effect on the fund's operations; and (5) whether the fund/service provider has remediated or is currently remediating the incident.

Third-Party Oversight

Policies and Procedures

- The policies and procedures mandated by proposed Rule 38a-2 must:
 - Identify fund service providers that receive, maintain or process fund information or are permitted to access fund information systems
 - Assess the cybersecurity risks associated with the fund's use of these service providers
 - Require oversight of those service providers
 - Document that the service providers, pursuant to written contracts with the fund, are required to implement and maintain appropriate cybersecurity measures
 - Those appropriate cybersecurity measures are the same as those required of the funds

Role of Board

Board Oversight and Reporting

- Fund boards would be required to initially approve the policies and procedures and review the annual written report regarding cybersecurity incidents and material changes to the fund's policies and procedures.
- "Board oversight should not be a passive activity. . ."
- SEC states that fund board approval is intended to facilitate the board's oversight and provide "accountability"
 - This appears to open the door to enforcement actions against board members

Board Oversight and Reporting

- The SEC provides some guidance for boards:
 - Should ask questions and seek relevant information regarding
 - Effectiveness of program
 - Adequacy of resources, including access to expertise
 - Cybersecurity risks arising from the program
 - Any incidents that have occurred
 - Boards should also consider what level of oversight of service providers is appropriate
 - May review contract and risk assessment (or summaries thereof)
 - Follow up regarding questions about the contract or weaknesses found in risk assessments
 - **Note:** Board may satisfy its obligation to approve a fund's policies and procedures by reviewing summaries. See proposing release note 52 and page 38.

Board Oversight Issues

- Should board approval be required?
 - Will board need to engage an expert?
 - Can board rely on third-party reviews or certifications by a fund's service providers?
 - Will fund/board have bargaining power to require changes in policies, procedures for major third-party service providers, e.g., custodian or transfer agent?
 - Is it necessary or appropriate for multiple boards to approve service providers' policies and procedures, when those service providers are independently regulated and subject to requirements as to cybersecurity?
 - **Note:** As per above, the fund's policies and procedures must address service providers, so board approval encompasses those elements of the policies and procedures that pertain to service providers

Board Oversight Issues (cont.)

- Should approval be based on some particular finding, e.g.:
 - Policies and procedures are reasonably designed to prevent violations of federal securities laws?
 - Does that merely duplicate Rule 38a-1?
 - Policies and procedures are reasonably designed to address the fund’s cybersecurity risks?
 - That is the standard applicable to funds and advisers under the proposed rules.
- If approval is not based on a particular finding, what does it mean?
 - Is it enough to “check the boxes” to ensure that on their face policies and procedures include the mandated elements?
- What is scope of approval of policies and procedures as they relate to service providers?
 - Extend to third/fourth parties, e.g., cloud storage services, trade order management systems?
 - In the Release, the SEC refers to cloud storage services and order management systems as service providers covered by the rules.

Final Thoughts

1

Fund Boards need additional clarity regarding oversight role.

- Standard for board approval of cybersecurity policies and procedures
- Oversight of fund third-party service providers

2

Implementation of the rules will be yet another heavy lift for funds, advisers, and boards.

Addendum

- On March 15, 2023, the SEC reopened the comment period for the proposed rules.
 - Comment period reopened until 60 days after publication in the Federal Register.
- The reopening is so that commenters may consider whether there would be any effects of other SEC proposals relating to cybersecurity that should be considered by the Commission.
- Other cybersecurity-related proposals include:
 - Reg. S-P rule amendments regarding privacy and safeguarding of consumer information.
 - Would require broker-dealers, investment companies, and registered investment advisers to adopt policies and procedures for incident response, including timely notification of affected individuals.
 - Cybersecurity Risk Management Rule relating to entities such as broker-dealers, FINRA, securities exchanges, and transfer agents.
 - Require policies and procedures to address cybersecurity risk and immediate notice to SEC of a significant cybersecurity incident.
 - Rules relating to an investment adviser’s outsourcing of “covered functions” including cybersecurity.

Addendum (cont.)

- These rule proposals—which would expand cybersecurity regulation of many market participants—underscore the question of whether it is necessary or appropriate for fund boards to approve cybersecurity policies and procedures that address service providers.
 - Those service providers are subject to independent, expanding cybersecurity regulation.

Liquidity Risk Management and Swing Pricing Proposal

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Proposed “Enhancements”

- SEC continues to be concerned about mutual fund liquidity
 - [REDACTED]
 - [REDACTED]
 - [REDACTED]
- Proposed “Enhancements” include:
 - Revisions to Liquidity Classifications
 - Swing Pricing/Hard Close



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SEC Proposes Enhancements to Open-End Fund Liquidity Framework

Related Materials

- [Proposed Rule](#)
- [Fact Sheet](#)

FOR IMMEDIATE RELEASE
2022-199

Washington D.C., Nov. 2, 2022 — The Securities and Exchange Commission today voted to propose amendments to better prepare open-end funds for stressed conditions and to mitigate dilution of shareholders' interests. The rule and form amendments would enhance how funds manage their liquidity risks, require mutual funds to implement liquidity management tools, and provide for more timely and detailed reporting of fund information.

"A defining feature of open-end funds is the ability for shareholders to redeem their shares daily, in both normal times and times of stress," said SEC Chair Gary Gensler. "Open-end funds, though, have an underlying structural liquidity mismatch. This can raise issues for investor protection, our capital markets, and the broader economy. We saw such systemic issues during the onset of the COVID-19 pandemic, when many investors sought to redeem their investments from open-end funds. Today's proposal addresses these investor protection and resiliency challenges."

Currently, open-end funds other than money market funds and most exchange-traded funds are required to classify the liquidity of their investments into four categories, ranging from highly liquid to illiquid. The proposal seeks to improve these funds' liquidity classifications by establishing new minimum standards for classification analyses, including some that incorporate stressed conditions, and by updating the liquidity categories to limit the extent of a fund's investments in securities that do not settle within seven days. These changes are designed to help better prepare funds for stressed conditions and prevent funds from over-estimating the liquidity of their investments. Affected funds would also be required to maintain a minimum amount of highly liquid assets of at least 10 percent of net assets to help manage stressed conditions and heightened redemption

Liquidity Risk Management

- Liquidity Classification Changes – Goodbye, Bank Loan Funds!
 - “Less Liquid” category is eliminated
 - Securities valued in accordance with Level 3 are now all “Illiquid”
- Daily Classification Changes (rather than “no less frequently than monthly”)
 - This was a hard-fought provision by the industry in the initial proposal
- No more asset class classifications
 - This is more significant than it seems
- Prescriptive value impact standard (20% 20-day ADV OR 1% market impact)
- Prescriptive RATS (10%) (RATS actually replaced with “stressed trade size”)
- Prescriptive HLIM (10%)

Swing Pricing – What Is It?

- Additional step in the calculation of a mutual fund's NAV when certain daily investment flow thresholds are exceeded
- Goal is to pass on transaction costs stemming from inflows or outflows (i.e., to buy or sell portfolio securities) to the purchasing or redeeming investors

Swing Pricing – How Would It Work?

- Is the fund in net purchases or net redemptions for the day?
- If so, by how much?
- If net purchases, do they exceed 2% of the fund's assets?
- Net redemptions would always trigger a downward swing of the NAV. If net redemptions exceed 1% of the fund's net assets, then include market impact in the downward NAV adjustment
- Swing factor
 - Cost to sell a vertical slice of the fund's portfolio (versus actual cost)
- All of this requires the fund to know its shareholder activity before calculating NAVs....

The Swing Pricing Problem...

- Current methods of order delivery do not allow for the funds to know their shareholder activity early enough in the day to calculate NAV.

Current Structure:



Enter ... the Hard Close

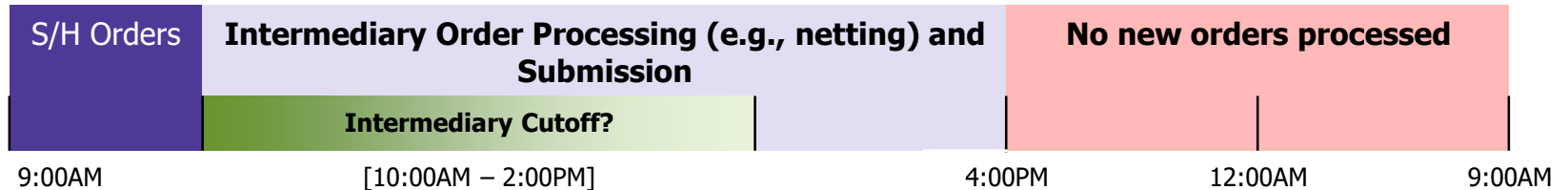
- Under the Proposal, an order MUST be received by the fund, its designated transfer agent, or a registered securities clearing agency before the NAV is calculated (typically 4 pm ET)
- Currently, orders may be received by a fund intermediary before the NAV is calculated
- Approximately 60% (or more) of trades flows are transmitted to DTCC after 4:00 pm ET
- The majority of retirement plan trades are received by the funds the next morning (in the very last DTCC cycle)

Small revisions ... BIG change

Current Structure:



Hard Close Structure (Intermediary Cut-Off Time):

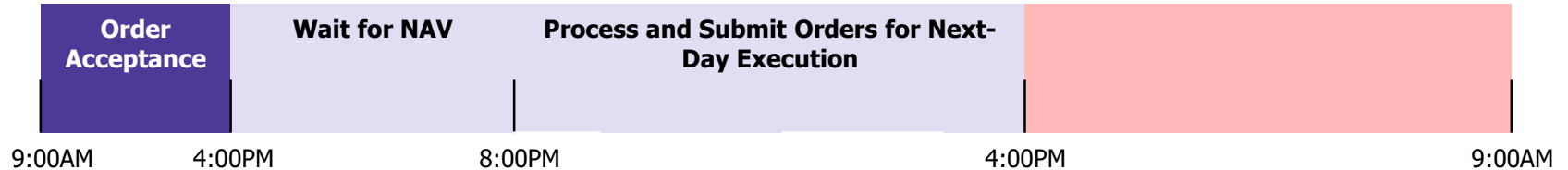


Hard Close Challenges

- Operations (dividend reinvestment/corporate actions)
- Shareholder understanding/disclosure/expectations
- Shareholder expectations
- Comparability of funds/intermediary competition on operational speed
- Incentivizes move to less regulated products
- Catch-22 for certain retirement plans

Hard Close and Retirement Plans

- Current processes require daily price information to process investment instructions
- Order processing cannot happen until after NAV is received



The End

Q&A

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With more than a decade of experience as senior in-house counsel with global investment managers, **Lance** has a deep understanding of mutual fund law and operation and is fluent in the myriad regulations applicable to investment managers. He is well versed in the creation of investment products and environmental, social and governance (ESG) and sustainability matters. Lance works extensively on regulatory policy matters engaging with various financial services regulators, including the US Securities and Exchange Commission, US Department of Labor, Internal Revenue Service, and US Department of Treasury.

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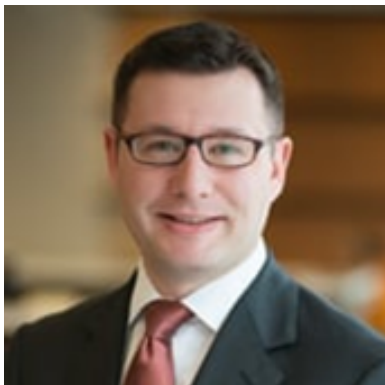
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Laura's practice focuses on the regulation of investment companies and investment advisers. Laura regularly represents exchange-traded funds (ETFs), mutual funds, and variable insurance-dedicated products, as well as their sponsors and boards of directors, 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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The investment management world is complex and highly regulated, and **David** works closely with mutual funds, exchange-traded funds (ETFs), closed-end funds, private funds, and their investment advisers to navigate the shifting terrain. He brings particular experience in launching new fund complexes, from identifying legal issues that arise from proposed fund strategies, through initial US Securities and Exchange Commission (SEC) registration, organizational board of directors' meetings, and fund seedings.

David advises clients on a range of legal, regulatory, and transactional matters, including fund formation, ongoing compliance, and corporate governance. He also counsels clients on the creation and continuing operation of liquid alternative funds. In addition to drafting fund documents such as registration statements, proxy materials, information statements, and exemptive applications, David has experience in closing fund reorganizations and mergers, including drafting reorganization agreements, proxy statements and prospectuses, and related closing documents.

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Sean 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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Roger's practice encompasses both publicly offered and private investment funds, and includes representation of funds, sponsors and independent directors. He is known for advising clients on the evolving federal regulatory environment for funds and managers, including under the Dodd-Frank Act and the Volcker Rule as well as federal securities laws. Roger has participated in many innovative developments in the investment management industry, including heading up the legal team that developed the master/feeder legal structure and shepherding the first funds using that structure through the US registration process. He also led the investment management team in the legal structuring of the first principal-protected, actively managed mutual funds.

Roger has led many major projects, including restructurings of major fund complexes. He was co-leader of the legal team that reorganized more than 100 open and closed-end funds governed by eight separate boards, in connection with the acquisition of a large asset management organization by another large financial services firm. He also served as co-leader of the legal team that served as an Independent Compliance Consultant under applicable regulatory orders in reviewing a major mutual fund adviser's compliance with federal and state securities laws.

Roger is a frequent guest speaker at industry panels and is regularly quoted in industry publications and the business press. His clients include registered mutual funds and closed-end funds, investment advisers, and independent directors as well as sponsors of private equity funds, hedge funds, and offshore funds.

Before joining Morgan Lewis, Roger was the co-chair of the global financial services practice of another international law firm and a member of its executive board.

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Jonathan advises investment companies, investment advisers, and private funds on a variety of regulatory compliance, corporate, and transactional matters. Jon counsels clients in all aspects of their organization, registration, operation, and liquidation. In addition, Jon advises broker-dealers on various matters, particularly with respect to regulatory compliance issues, market making activities, and transactions in exchange-traded funds. Jon is also a member of the firm's environmental, social, and governance (ESG) and sustainability working group, and regularly counsels clients on ESG investing strategies, disclosure, and related regulatory issues.

Before joining Morgan Lewis, Jon served in various compliance, risk management, and legal roles at an international bank and broker-dealer, a large national law firm, and a global investment bank. He also previously held a FINRA Series 7 license.

THANK YOU

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