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REGISTERED FUNDS TRENDS AND DEVELOPMENTS

Quarter in Review Series: Sixth Edition

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Overview

- Latest on ESG Regulatory Oversight
- Risk Alert: Registered Fund Compliance Obligations
- Rules Readiness - Fund of Funds, Derivatives, and Valuation
- Potential Upcoming Cross-Trade Issues

Latest on ESG Regulatory Oversight

- The SEC Staff continues to express concerns over “greenwashing,” (i.e., funds held out as more ESG-focused than they actually are)
- SEC Chairman Gensler noted at the SEC’s Asset Management Advisory Committee (AMAC) meeting in July that he directed the SEC Staff to take a holistic look at the naming conventions for funds, including those with environmental, social, and governance (ESG) or “sustainable” investment strategies
 - Chairman Gensler’s comments follow the 2020 SEC request for comments on a number of topics relating to the Names Rule (Rule 35d-1), which garnered substantial input from industry participants regarding, among other things, ESG funds
 - During his prepared remarks at the AMAC meeting, Chairman Gensler indicated a renewed SEC focus on exploring revisions to the Names Rule
- The SEC Staff has been increasing its comments relating to ESG through the registration statement disclosure review process
- New SEC rules relating to disclosure requirements as they apply to climate-related risks and strategies and other ESG matters are expected soon
- On August 6, the DOL submitted a proposed rule related to ESG investments, which was published in the *Federal Register* on October 14. The proposed rule would remove barriers put in place by the prior administration, one of which would have required plan fiduciaries to consider only “pecuniary factors” when selecting investments and investment courses of action

Risk Alert: Registered Fund Compliance Obligations

- Staff from the SEC's Division of Examinations published risk alert on October 26, 2021 summarizing observations coming out of a series of examinations from 2018 and 2019 of mutual funds and ETFs, specifically focusing on retail investor issues
- Risk alert notably highlighted deficiencies and weaknesses in almost every area of mutual fund and fund adviser compliance obligations
- Although many of the observations were straightforward, there were some particularly interesting observations:
 - Deficiencies in the "oversight of the viability of smaller and/or thinly traded ETFs ... and their liquidation," as well as funds' failure to have board reporting processes regarding "whether a fund's liquidation may be in the best interests of the fund and its shareholders"
 - Deficiencies related to "sharing of soft-dollar commissions among clients to assess whether any client is disadvantaged"
 - Deficiencies where advisers did not review index provider relationships for (1) conflicts of interest with advisers (e.g., shared personnel or other business relationships, such as revenue sharing); and (2) the sharing, or the potential misuse, of material non-public information
 - Inadequate compliance policies and procedures with respect to "specific risks associated with each fund's investments such as asset classes that present certain operational or other risks"
- The Staff noted several observations of compliance practices that advisers may find helpful in their compliance oversight practices
- Risk Alert concluded by encouraging registered funds and their advisers to review their practices, policies, and procedures generally

Rules Readiness - Fund of Funds

- On October 7, the SEC adopted the Fund of Funds Rule (Rule 12d1-4) and related amendments; funds have until January 2022 to comply with the Rule
- Highlights of the Rule:
 - Rule is available to registered funds and BDCs seeking to invest in other registered funds and BDCs beyond the limits currently imposed by Section 12(d)(1) of the 1940 Act, assuming certain conditions are satisfied
 - Designed to provide a more consistent and efficient regulatory framework for funds that invest in other funds
 - Rule 12d1-2 and most exemptive orders granting relief from certain provisions of Section 12(d)(1) of the 1940 Act were rescinded, and certain no-action letters withdrawn
 - An acquiring fund must comply with five general conditions in order to utilize Rule 12d1-4: (1) limits on control and voting; (2) required evaluations, findings, and reports; (3) required fund of funds investment agreements; (4) limits on complex structures; and (5) recordkeeping requirements
 - Acquired funds must also make certain findings before entering into fund of funds investment agreements

Rules Readiness – Derivatives Rule

- On October 28, the SEC adopted the new derivatives rule (Rule 18f-4); the Rule became effective February 19, 2021 and funds have until August 19, 2022 to comply
- Highlights of the Rule:
 - Applicable funds must adopt a Derivatives Risk Management Program and appoint a Derivatives Risk Manager
 - Funds that use derivatives to a limited extent (i.e., 10% or less of net assets, excluding currency and interest rate hedges) will only have to adopt policies and procedures reasonably designed to manage related risks
 - Permitted levels of investment in derivatives will be subject to either a relative Value-at-Risk test based on a designated reference portfolio, or absolute Value-at-Risk test, with at least daily compliance testing
 - Leveraged and inverse funds will be permitted, but effectively will be limited to 200% Value-at-Risk, and an expansion of the ETF Rule (Rule 6c-11) that the SEC simultaneously adopted will permit new leveraged and inverse ETFs to come to market if they comply with the rule
 - Funds will be permitted to treat reverse repurchase agreements and similar financing transactions as derivatives for purposes of the rule, or can subject those transactions to the asset coverage requirements of Section 18
 - The SEC did not adopt asset segregation requirements proposed in December 2015

Rules Readiness – Valuation Rule

- On December 3, the SEC adopted Rule 2a-5, which establishes an updated regulatory framework for fund valuation practices. The rule became effective March 8, 2021 and funds have until September 8, 2022 to comply
- Highlights of the Rule:
 - Determining fair value in good faith will require assessing and managing material risks associated with fair-value determinations; selecting, applying, and testing fair-value methodologies; and overseeing and evaluating any pricing services used
 - A board may designate the fund’s adviser or, if the fund does not have an adviser, an officer or officers of the fund as the “valuation designee” to perform determinations of fair value
 - Assuming a fund board appoints a “valuation designee,” the board’s role effectively will be limited to one of oversight, and the Rule establishes a principles-based framework for such oversight
 - The recordkeeping requirements were moved into a new, separate rule: Rule 31a-4
 - The SEC stated that the Rule’s definition of “readily available market quotations” will apply to all relevant provisions of the 1940 Act and rules thereunder

Potential Upcoming Cross Trade Issues

- Pursuant to Rule 17a-7 under the 1940 Act, securities transactions may be effected between a fund and certain affiliates (referred to as “cross trades”), provided the transactions meet certain protective conditions. One such condition is that the trade involve a security for which market quotations are “readily available”
- The new Valuation Rule includes a definition of the term “readily available market quotations” that may affect current investment company cross-trading practices under Rule 17a-7. In response to the Rule’s proposal, a number of commenters stated that funds and their affiliates regularly engage in cross-trades of certain fixed-income securities that they believed would not qualify as having readily available market quotations under the definition of that term in the Rule
- Accordingly, certain securities that some may have previously viewed as having readily available market quotations under Rule 17a-7 may not meet the definition in the Valuation Rule and may not be available for such trades after September 8, 2022
- Consideration of potential amendments to Rule 17a-7 is on the rulemaking agenda, which would potentially have additional implications for cross-trades entered into by funds

Coronavirus COVID-19 Resources

We have formed a multidisciplinary **Coronavirus/COVID-19 Task Force** to help guide clients through the broad scope of legal issues brought on by this public health challenge.

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To help keep you on top of developments as they unfold, we also have launched a resource page on our website at

www.morganlewis.com/topics/coronavirus-covid-19

If you would like to receive a daily digest of all new updates to the page, please visit the resource page to **subscribe** using the purple “Stay Up to Date” button.



Attorney Biographies

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With more than a decade of experience as senior in-house counsel with global investment managers, Lance Dial 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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Elizabeth Belanger provides legal advice with respect to a wide variety of financial services products and providers, including registered mutual funds, investment advisers, broker-dealers, bank-sponsored collective trust funds, variable annuities, and insurance companies. Elizabeth has a specific focus on financial services products offered through defined contribution retirement plans and the unique issues that may affect those offerings.

Elizabeth regularly advises clients regarding compliance policies and procedures and related regulatory matters. She advises clients regarding the formation of registered mutual funds and unregistered bank collective trusts, and the development of registered and unregistered variable annuity contracts.

Prior to joining the firm, Elizabeth was Vice President and Associate General Counsel at Transamerica Retirement Solutions, where she provided advice regarding a variety of investment-related issues affecting retirement plan services.

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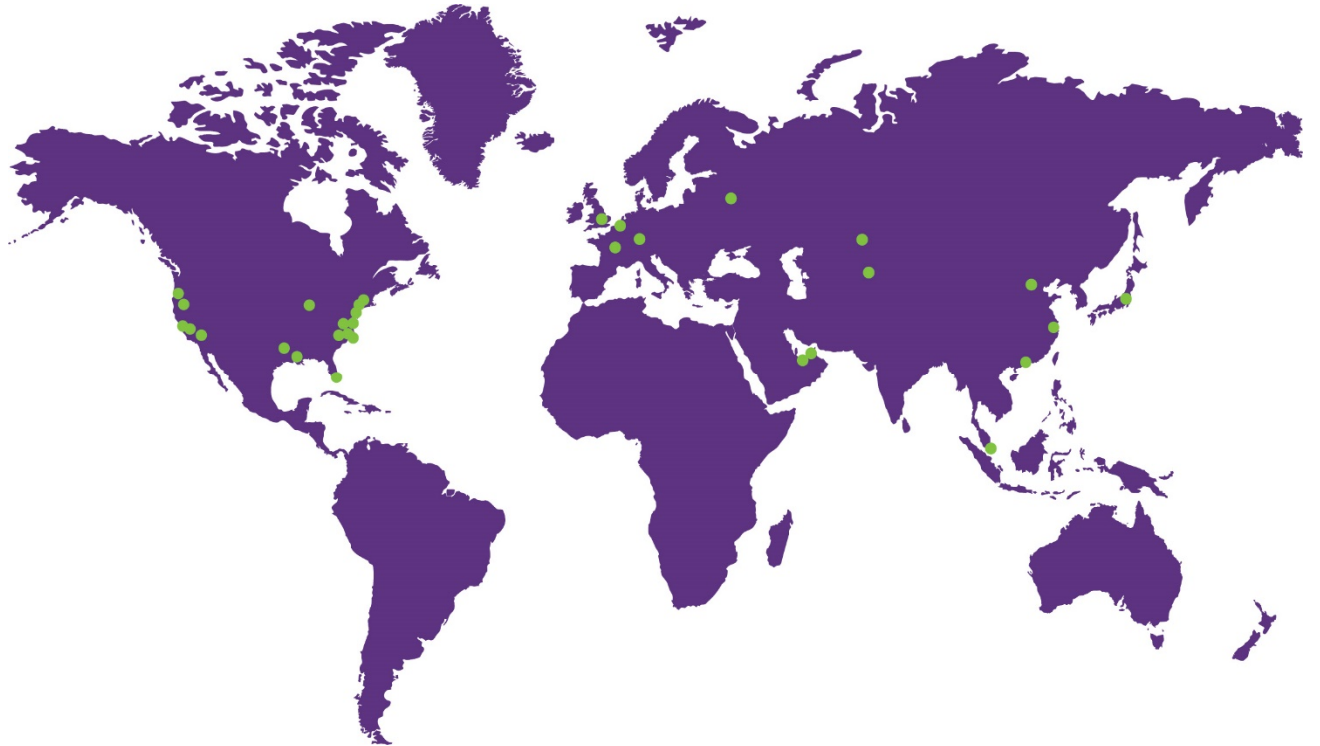
Brian T. London represents mutual funds, exchange-traded funds (ETFs), closed-end funds, private funds, and their investment advisers in US and international legal, regulatory, and transactional matters. His experience extends to work in several areas, including the development and launch of new funds, fund reorganizations, corporate governance matters, and ongoing compliance issues. Additionally, Brian counsels investment adviser clients on the applicability and interpretation of securities laws, including with respect to business combinations, registration and disclosure, and pay-to-play issues.

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