VedderPrice

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Investment Services Regulatory Update

New Rules, Proposed Rules and Guidance

SEC Adopts New Rules Mandating Open-End Fund Liquidity Risk Management Programs and Permitting Swing Pricing

On October 13, 2016, the SEC adopted new Rule 22e-4 under the 1940 Act (the liquidity rule), which will require open-end funds, including ETFs but excluding money market funds, to adopt and implement comprehensive liquidity risk management programs, and an amendment to Rule 22c-1 under the 1940 Act (the swing pricing rule), which will permit open-end funds, excluding ETFs and money market funds, to use "swing pricing," a mechanism by which a fund may adjust the net asset value per share at which purchases and redemptions are effected to mitigate the dilutive effect purchase and redemption activity may have on the interests of continuing investors. While the final swing pricing rule was adopted largely as proposed in September 2015, the final liquidity rule, in response to industry comments, reflects significant changes from the proposal.

For a more detailed discussion of the liquidity rule and the swing pricing rule, please see the Vedder Price White Paper, "SEC Adopts New Rules Mandating Open-End Fund Liquidity Risk Management Programs and Permitting Swing Pricing," published on October 28, 2016 and available at: http://www.vedderprice.com/SEC-Adopts-New-Rules-Mandating-Open-End-Fund-Liquidity-Risk-Management-Programs-and-Permitting-Swing-Pricing-10-28-2016/.

Liquidity Rule

Background. The SEC has long provided guidance to open-end funds regarding investments in illiquid securities for the primary stated goal of ensuring that funds have sufficient liquid assets to satisfy redemption requests within required periods, including the seven-day period required by the 1940 Act. Citing this and other concerns, such as the growth of funds using relatively less liquid investment strategies (e.g., high-yield and alternative strategies) and the promotion of efficient ETF trading and operations, and following a two-year staff review of industry practices concerning liquidity risk management, the SEC proposed and adopted the liquidity rule. The rule was "designed to promote effective liquidity risk management throughout the open-end fund industry and thereby reduce the risk that funds will not be able to meet redemption or other legal obligations and mitigate potential dilution of the interests of fund shareholders." The liquidity rule replaces current SEC guidance regarding open-end funds' investments in illiquid securities.

Liquidity Risk Management Program. The liquidity rule requires each registered open-end fund, including ETFs but excluding money market funds, to adopt and implement a written liquidity risk management program. ETFs that satisfy redemptions solely in kind using no more than a *de minimis* amount of cash (In-Kind ETFs) are exempt from certain requirements of the liquidity rule. The policies and procedures constituting a liquidity risk management program must incorporate the following five elements:

1. **Assessment, Management and Review of Fund Liquidity Risk**. Based on a consideration of specified factors, a fund (including In-Kind ETFs) must assess, manage and review at least annually its "liquidity risk," which is defined as the risk that the fund could not meet requests to redeem shares without significant dilution of remaining investors' interests.

2. **Liquidity Classification of Portfolio Investments.** A fund (excluding In-Kind ETFs) must classify its portfolio investments, including derivative instruments, into the following four liquidity categories:

   - **Highly liquid investments**—cash and investments that may be converted into cash *within three business days* without a significant change in market value.
   - **Moderately liquid investments**—investments that may be converted into cash *within seven calendar days, but in more than three calendar days*, without a significant change in market value.
   - **Less liquid investments**—investments that may be sold or disposed of *within seven calendar days* without a significant change in market value, *but which settle in more than seven calendar days*.
   - **Illiquid investments**—investments that *cannot be sold or disposed of within seven calendar days* without a significant change in market value.

   Classifications must be based on information obtained after reasonable inquiry and take into consideration relevant market, trading and investment-specific considerations, as well as market depth. Classifications may be based, by default, on asset class, unless a fund or its investment adviser is aware of a reason a particular investment should be classified differently. Classifications must be reviewed at least monthly and reported on Form N-PORT.

3. **Highly Liquid Investment Minimum.** A fund (excluding In-Kind ETFs) that does not "primarily" hold highly liquid investments must set a minimum percentage of net assets that will be invested in such investments and review this minimum at least annually. Any shortfall of the highly liquid investment minimum must be reported to the board at its next regular meeting. If a shortfall continues for more than seven days, both the board and the SEC, in a confidential filing on new Form N-LIQUID, must be immediately notified, and a plan must be prepared to return the fund to compliance.

4. **Illiquid Investments.** Similar to current SEC guidance, a fund (including In-Kind ETFs) may not acquire an illiquid investment if, immediately after the acquisition, more than 15 percent of its net assets would be invested in illiquid investments. In addition, if a fund's illiquid investments exceed 15 percent at any time, both the board and the SEC, in a confidential filing on new Form N-LIQUID, must be immediately notified, and a plan must be prepared to return the fund to compliance.

5. **Redemptions In Kind.** Any fund (including In-Kind ETFs) that satisfies, or reserves the right to satisfy, redemptions in kind, must establish policies and procedures regarding how and when redemption requests will be satisfied in kind.

Board Responsibilities. The role of the board under the liquidity rule is one of general oversight. The board, including a majority of independent board members, must initially approve a fund's liquidity risk management program and designate either the fund's investment adviser or one or more officers as the person or persons responsible for administering the program. The board must also review at least annually a written report from the program administrator addressing the operation of the program and assessing its adequacy and effectiveness.

Disclosure, Reporting and Recordkeeping Requirements. In connection with the liquidity rule, the SEC amended Form N-1A to require disclosure of certain matters relative to redemption practices in the prospectus, and amended new Form N-CEN to require the annual disclosure of various liquidity-related matters. The SEC also amended new Form N-PORT to require funds to report the liquidity classifications of their portfolio investments, as well as, if applicable, their highly liquid investment minimums and information regarding shortfalls of the highly liquid investment minimum. (For a more detailed discussion of the new reporting requirements, please see "SEC Adopts Rules to Modernize and Enhance Investment Company Reporting" below.) In addition, the SEC adopted certain recordkeeping requirements relating to the liquidity risk management program.

Compliance Date. Funds in groups of related investment companies with $1 billion or more in net assets must comply with the liquidity rule by December 1, 2018; other funds must comply by June 1, 2019.

The adopting release for the liquidity rule, Investment Company Liquidity Risk Management Programs, Investment Company Act Release No. 32315 (Oct. 13, 2016), is available at https://www.sec.gov/rules/final/2016/33-10233.pdf.

Swing Pricing Rule

What Is Swing Pricing? The 1940 Act generally requires that open-end fund shares be priced at the net asset value per share next computed after the receipt of a purchase or redemption request. The swing pricing rule provides an exception to this requirement that permits, but does not require, an open-end fund, excluding ETFs and money market funds, to use "swing pricing" to adjust the net asset value per share at which purchases and redemptions are effected in order to mitigate the dilution of continuing investors' interests resulting from purchase and redemption activity. Under swing pricing, if net redemption activity on a particular day exceeds a certain threshold, a fund's net asset value per share for that day is adjusted downward; if net purchase activity on a particular day exceeds a certain threshold, a fund's net asset value per share for that day is adjusted upward. Swing pricing is currently used by collective investment vehicles in certain non-U.S. jurisdictions.

Swing Pricing Policies and Procedures. Under the swing pricing rule, the use of swing pricing will be optional. However, if a fund elects to use swing pricing, the fund must establish swing pricing policies and procedures that require the fund to adjust its net asset value per share by a stated percentage (a Swing Factor) once the level of net purchases into, or net redemptions from, the fund has exceeded a stated threshold amount (a Swing Threshold). A fund may establish multiple Swing Thresholds at differing levels of net purchases or net redemptions and have different Swing Factors that are triggered when net purchases or net redemptions exceed these Swing Thresholds. The policies and procedures must also specify the process for determining a fund's Swing Threshold(s) and Swing Factor(s), in each case based on a consideration of specified factors. A fund must establish an upper limit on its Swing Factor(s), which may not exceed 2 percent of net asset value per share. In the operation of a fund's swing pricing, a determination of whether daily net purchases or net redemptions have exceeded a Swing Threshold may be made based on a "reasonable high-confidence estimate" of daily investor flows.

Role of the Board and Administration of Swing Pricing. Under the swing pricing rule, the board, including a majority of independent board members, must approve a fund's swing pricing policies and procedures, as well as the fund's Swing Threshold(s) and the upper limit on the Swing Factor(s) used and any changes to the Swing Threshold(s) or upper limit. The board, including a majority of independent board members, must also designate the fund's investment adviser or one or more fund officers as the person or persons responsible for administering the swing pricing policies and procedures.

In addition, the board, including a majority of independent board members, must review at least annually a written report from the swing pricing administrator reviewing the adequacy of the fund's swing pricing policies and procedures and the effectiveness of their implementation, including the impact on mitigating dilution.

Disclosure and Recordkeeping Requirements. In connection with the swing pricing rule, the SEC amended Form N-1A to require certain disclosure in the summary prospectus regarding swing pricing, including a discussion of when swing pricing is used and the effect of swing pricing on performance. The SEC also amended the financial highlights requirements to require disclosure of the effect of swing pricing adjustments on net asset value per share and per-share amounts retained by a fund pursuant to swing pricing. The SEC amended Regulation S-X to require certain swing pricing-related disclosures in financial statements, and amended new Form N-CEN to require a fund to disclose whether it actually used swing pricing during the reporting period and the fund's Swing Factor upper limit. The SEC also adopted certain recordkeeping requirements relating to swing pricing policies and procedures and the calculation of swing pricing-related adjustments to net asset value per share.

Compliance Date. The effective date of the swing pricing rule will be 24 months after publication in the Federal Register. The delayed effective date is intended to allow for the creation and implementation of efficient and cost-effective solutions to the operational challenges presented by swing pricing.

The adopting release for the swing pricing rule, Investment Company Swing Pricing, Investment Company Act Release No. 32316 (Oct. 13, 2016), is available at https://www.sec.gov/rules/final/2016/33-10234.pdf.

SEC Adopts Rules to Modernize and Enhance Investment Company Reporting

On October 13, 2016, the SEC voted to adopt rules, forms and amendments that are intended to modernize and enhance the reporting and disclosure of information by investment companies. The new rules will enhance data reporting for mutual funds, ETFs and other registered investment companies. With these rules, registered funds will be required to file a new monthly portfolio reporting form (Form N-PORT) and a new annual reporting form (Form N-CEN) that will require census-type information. The information will be reported in a structured data format, which will allow the SEC and the public to better analyze the information provided by filers. The rules also will require enhanced and standardized disclosures in financial statements and will add new disclosures in fund registration statements relating to a fund's securities lending activities.

Form N-PORT and the Elimination of Form N-Q

The SEC adopted a new portfolio holdings report, Form N-PORT, that will be filed by all registered management investment companies (other than money market funds and small business investment companies) and unit investment trusts (UITs) that operate as exchange-traded funds (ETFs). Form N-PORT will require funds to report certain information about the fund and the fund's portfolio investments as of the close of the preceding month, including: (a) general information about the fund; (b) fund assets and liabilities; (c) certain portfolio-level metrics, including certain risk metrics; (d) information regarding securities lending counterparties; (e) monthly returns; (f) flow information; (g) certain information regarding each investment in the portfolio; (h) miscellaneous securities (if any); (i) explanatory notes (if any), and (j) exhibits.

Form N-PORT will require funds to report the fund's complete portfolio holdings and certain new information not currently required to be reported elsewhere. For example, Form N-PORT will require reporting of additional information relating to derivative investments and certain portfolio level risk metric calculations that measure a fund's exposure and sensitivity to changing market conditions (e.g., changes in asset prices, interest rates, or credit spreads).

Reports must be filed with the SEC on a monthly basis, within 30 days after the close of each month, in a structured data format that facilitates collection and analysis of the data by the SEC. Once filed, the report for every third month will become available to the public 60 days after the end of the fund's fiscal quarter.

The compliance date for new Form N-PORT is June 1, 2018 for funds that, together with other funds in the same "group of related investment companies," hold net assets of at least $1 billion or more as of the end of the most recent fiscal year. Smaller fund families must comply by June 1, 2019. With the adoption of new Form N-PORT, the SEC will rescind Form N-Q, the current portfolio holdings report which is filed at the end of a fund's first and third fiscal quarter (no later than 60 days after the period ends). The adopting release explains that the rescission of Form N-Q is effective August 1, 2019 (2 months after the latter N-PORT compliance date) to allow funds sufficient time to satisfy Form N-Q's 60-day filing requirement with regard to their final filing on Form N-Q for the reporting period preceding their first filing on Form N-PORT.

Form N-CEN and Elimination of Form N-SAR

The SEC adopted a new annual reporting form, Form N-CEN, that will require all registered investment companies (except face amount certificate companies) to annually report certain census-type information to the SEC. Form N-CEN will replace Form N-SAR, the form currently used to report fund census information. The new form will include many of the same reporting elements of Form N-SAR but would eliminate certain outdated items and items of limited usefulness. The new form will require funds to provide, among other changes, information on whether a fund service provider was hired or terminated during the reporting period and whether it is affiliated with the fund or its adviser(s).

Reports must be filed annually within 75 days of the end of the fund's fiscal year, rather than semi-annually as is currently required by Form N-SAR for most funds. The compliance date for Form N-CEN is June 1, 2018.

Amendments to Regulation S-X

The SEC adopted amendments to Regulation S-X that will modify the presentation and content of fund financial statements which are included in shareholder reports and fund registration statements. Among other things, the amendments will require the presentation of standardized disclosure regarding fund holdings in various open futures, forwards and swap contracts, as well as for any written and purchased option contracts. The amendments also will enhance the prominence of derivatives-related disclosures in a fund's schedule of investments, instead of in the notes to the financial statements. In addition, the amendments require new disclosures in the notes to the financial statements relating to a fund's securities lending activities.

The compliance date for the amendments to Regulation S-X is August 1, 2017.

The SEC release relating to these new fund rules, "Investment Company Reporting Modernization," Investment Company Act Release No. 32314 (October 13, 2016), is available at: https://www.sec.gov/rules/final/2016/33-10231.pdf.

SEC Requests Comment and Data on the Extension of Proposed Universal Proxy Requirements to Funds

On October 26, 2016, the SEC proposed amendments to the proxy rules that would require the use of a "universal proxy" – a proxy card that includes the name of all duly nominated director candidates for whom proxies are solicited – for all non-exempt solicitations in contested elections. The proposed universal proxy seeks to address the issue that shareholders voting by proxy are limited to the selection of candidates provided by the soliciting party, whereas shareholders voting in person may select among all of the duly nominated director candidates proposed by any party and vote for any combination of those candidates. In this regard, the proposed universal proxy is based on the SEC's view that the proxy voting process "should mirror to the greatest extent possible the vote that a shareholder could achieve by attending the shareholders' meeting and voting in person."

As proposed, the amendments would not apply to registered funds and business development companies (BDCs). In this connection, the SEC observed that, among other things, open-end funds are generally not required to hold annual shareholder meetings pursuant to the state laws under which they are organized and that contested elections at such funds are rare. For exchange-listed closed-end funds and BDCs, as to which contested director elections are more common compared to open-end funds, dissidents in elections generally have not sought split-ticket voting and, instead, have sought to reduce discounts to net asset value (NAV) either by gaining control of the board of directors or terminating the fund's advisory contract and subsequently replacing the adviser.

Notwithstanding these observations, the proposing release issued by the SEC seeks comment and data to further inform the SEC as to whether the use of universal proxies should be required in proxy contests for the election of directors of funds or BDCs. Among the questions raised in the proposing release are:

- Should the use of universal proxies be mandatory as applied to investment companies generally, or should their use be mandatory only with respect to certain types of investment companies (e.g., only to closed-end funds or only BDCs)? Should it be optional? Should a hybrid system be applied?
- Should any aspect of the proposed universal proxy system be modified to account for the unique characteristics of investment companies? Would a universal proxy system affect funds and BDCs differently than operating companies?
- How would a universal proxy system affect unitary or cluster boards?
- Would the frequency of contested elections increase or decrease for investment companies under a universal proxy system?
- To what extent do investment companies generally, and open-end funds, closed-end funds and BDCs in particular, experience exempt solicitations under the current proxy rules?
- Should special rules regarding notice apply for investment companies that do not regularly hold annual meetings?

Comments on the proposed rule amendments are due on or before 60 days after publication in the federal register. The SEC's proposing release is available at: https://www.sec.gov/rules/proposed/2016/34-79164.pdf.

SEC Staff No Longer Requires "Tandy" Representations in Filing Review

On October 5, 2016, the staff of the SEC announced that, with immediate effect, it will no longer require companies (including funds) to include "Tandy" representations in their disclosure filing review correspondence. Companies that have yet to provide requested Tandy representations no longer need to do so.

Tandy representations required a company to acknowledge in writing that the disclosure in the document was its responsibility and to affirmatively state that it would not raise the SEC review process and acceleration of effectiveness as a defense in any legal proceeding.

Rather than requesting companies to make affirmative representations, the SEC staff will include the following statement in comment letters:

> "We remind you that the company and its management are responsible for the accuracy and adequacy of their disclosures, notwithstanding any review, comments, action or absence of action by the staff."

The announcement is available at: https://www.sec.gov/corpfin/announcement/cf-announcement---no-more-tandy-language.html.

Litigation and Enforcement Actions

SEC Settles Charges Against Adviser for Improper Fair Valuation of Bonds

On October 18, 2016, the SEC announced settled administrative proceedings against Calvert Investment Management, Inc. (the Adviser), a registered investment adviser, for improperly valuing bonds held by eight open-end mutual funds it advises (the Funds) and, consequently, executing shareholder transactions at an incorrect net asset value (NAV) and overstating performance. In addition, the SEC alleges that the Adviser collected inflated asset-based fees.

According to the SEC's order, between March 2008 and October 2011, the Funds acquired more than $1.2 billion principal amount of bonds issued by Toll Road Investors Partnership II, L.P. (the Bonds), complex and illiquid securities that at times had minimal external data points to facilitate valuation. The order states that in determining the Bonds' fair value, the Adviser relied primarily on the output of a third-party analytical tool. The SEC alleges that for an eight month period, the Adviser "failed appropriately to incorporate indicia of fair value into its fair value calculations, including, among others, the prices at which at which the [Funds] traded the [Bonds], values assigned by other holders of the [Bonds], and other market data." In this regard, the order states that the Adviser's fair value price was significantly higher than market prices paid by the Funds in purchases of the Bonds on several occasions, with "no clear indication that those trades involved distressed sales that might be afforded less weight in fair value calculations." The SEC also alleges that the Adviser failed to back-test the Bonds' fair value determinations, despite back-testing other portfolio holdings.

The SEC order states that on October 19, 2011, the Adviser discovered that the third-party analytical tool was flawed since it did not properly account for the Bonds' future cash flows and, as result, substantially inflated the Adviser's fair value prices. The order further states that the Adviser revised its approach and developed its own cash flow model to recalculate the Bonds' fair value prices, with the effect of significantly reducing the fair value prices. Thereafter, the Adviser publicly stated that it had made a pricing adjustment resulting in decreased NAVs of the Funds.

The order notes that, in an attempt to remediate the harm caused by the improper valuation of the Bonds, the Adviser contributed $27 million to the Funds in December 2011 and distributed nearly all of the contributed amounts to accountholders of record as of October 19, 2011, with undistributed amounts retained by the Funds. However, the SEC alleges that the payment amount "was derived from an insufficient process, since it was neither based on complete transactional data nor otherwise effectuated in accordance with the [Funds'] existing policies and procedures," and thus, the Adviser failed to compensate some shareholders and undercompensated others and the Funds. In this connection, the SEC alleges that the Adviser's payment was an imprecise measurement of estimated harm to accountholders of record based on a netting out of subscription and redemption activity at the intermediary account level. Because the Adviser did not have data concerning underlying shareholder account activity in omnibus accounts, the SEC alleges that the remediation process was flawed and shareholders potentially received different distribution amounts depending on whether they transacted through an intermediary or directly with the Funds "despite having engaged in identical transactions in shares of the [Funds]." Although the Funds' SEC filings and the Adviser's communications disclosed that shareholders harmed by the improper valuation were accurately identified and made whole, the SEC alleges that the Funds and the Adviser failed to disclose that the remediation process was:

- based, in part, on an estimate and was inconsistent with the Funds' NAV error correction procedures; and
- disparately treated certain shareholders, depending on whether they transacted directly with the Funds or through an intermediary.

As a result of the foregoing conduct, the SEC found that, among other things, the Adviser violated Sections 206(2) and 206(4) of the Advisers Act, which prohibit any fraud or deceit upon a client and the making of any untrue statement of material fact (or omission thereof) or otherwise engaging in any fraudulent deceptive or manipulative act with respect to any investor in a pooled investment vehicle, respectively. The SEC also found that the Adviser violated Sections 17(a) and 34(b) of the 1940 Act, which prohibit affiliates from selling securities to registered investment companies and the making of untrue statements of material fact in any document filed pursuant to the 1940 Act, respectively. Finally, the SEC found that the Adviser violated Rules 22c-1 and 38a-1 of the 1940 Act, which prohibits transacting in investment company securities other than at NAV and requires the implementation of policies and procedures to prevent violations of the federal securities laws, respectively.

Pursuant to the terms of the order, the Adviser agreed to, among other things, recalculate the fair value of the Bonds for the relevant period using a valuation methodology and prices provided to the SEC staff, reprice each Fund's NAV, taking into account purchases and redemptions that occurred at incorrect NAVs and a performance adjustment, and thereafter, make distributions to accountholders pursuant to a detailed distribution methodology and processes set forth in the order. In addition, the Adviser was censured and agreed to pay a civil money penalty of $3.9 million and cease and desist from any violations (and future violations) of the laws violated by the foregoing conduct.

The SEC order is available at: https://www.sec.gov/litigation/admin/2016/ia-4554.pdf

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