

Rules Impacting Registered Funds

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AGENDA

- Valuation & Derivatives Rules
- Money Market Fund Reform
- ESG Disclosure Rule Proposals
- Names Rule Proposal
- Disclosure Modernization Rule





VALUATION & DERIVATIVES RULES: CHALLENGES FACED & LESSONS LEARNED



VALUATION RULE OVERVIEW

- Rule 2a-5 of the 1940 Act establishes requirements for satisfying a fund board's obligations to determine fair value of a fund's investments
 - *Board has the ability to designate to the adviser fair valuation responsibilities.*
- Under Rule 2a-5, a market quotation is considered “readily available” **only if** it is a quoted price (unadjusted) in active markets for identical instruments that a fund can access at the measurement date, provided that a quotation will not be readily available if it is not reliable
 - Effectively expands “fair value” to include, for example, evaluated prices provided by pricing services for fixed income securities or “Level 2” securities
 - Not reliable = not readily available (i.e., U.S. GAAP standards; additional inputs)
- The deadline for compliance with Rule 2a-5 was September 2022
 - Fourth quarter meetings will be the first time many fund boards will receive new or updated fair value reports that align with Rule 2a-5



DERIVATIVES RULE: OVERVIEW

- Rule 18f-4 relates to all mutual funds, ETFs, registered closed-end funds, and business development companies who enter into derivatives transactions
- Rule 18f-4 represents a comprehensive re-working of the regulation of derivatives, which was previously comprised of a patchwork of guidance
- The Rule replaces the “asset segregation” practices used by funds to address concerns about leverage with a more comprehensive framework focused on the leverage risk of the fund as a whole
- The rule focuses on leverage and risk management; Rule 18f-4 does not address all issues related to use of derivatives
- The compliance date for Rule 18f-4 was August 19, 2022



VALUATION & DERIVATIVES RULES

- John Hancock: Challenges Faced
 - Valuation Rule: Certain new implementation areas may present challenges: assessment and management of material valuation risks, testing of fair values, and oversight of pricing services
 - Derivative Rule: Shortly after the compliance date, the SEC staff began conducting exams and requesting documentation related to implementation of Rule 18f-4. Requests include material related to fund boards' oversight of compliance with Rule 18f-4
- John Hancock: Lessons Learned





MONEY MARKET FUND REFORM



PROPOSED RULE 2a-7 REFORMS

- Latest attempt by the SEC to reform the rule governing MMFs in response to concerns raised by the market conditions and liquidity constraints experienced by MMFs in 2020 in wake of COVID
- These issues are largely addressed by the proposed:
 - Removal of fees and gates requirements
 - Increased requirements for portfolio liquidity; and
 - Mandatory swing pricing requirements
- Components of the proposal which present the greatest operational and compliance concerns relate to the proposed:
 - Requirement of institutional MMFs (i.e., floating NAV MMFs) to adopt swing pricing; and
 - Requirement of government and retail MMFs (i.e., stable NAV MMFs) to determine that each financial intermediary has the capacity to redeem and sell MMF shares at a floating NAV

■ New comment period for proposed rules closed on November 1, 2020

56 +1.13%

SWING PRICING OVERVIEW

- Swing pricing is the process of adjusting a fund's current NAV such that the transaction price effectively passes on costs from shareholder redemptions to redeeming shareholders
- Institutional prime and tax-exempt MMFs will be required to adopt swing pricing policies and procedures to be implemented by a board-designated "swing pricing administrator"
- Required to calculate and apply a "swing factor" reflecting spread costs and other transaction costs of selling a vertical slice of the portfolio in any "pricing period" in which an institutional MMF has net redemptions
- Unlike the current swing pricing regime under Rule 22c-1, the swing factor would be applied whenever there are net redemptions, instead of redemptions beyond a specific swing threshold



CALCULATION OF SWING FACTORS

- For determining net redemptions, MMFs are permitted to take into account investor flow information for the pricing period, which may consist of individual, aggregated, or netted orders, and may include reasonable estimates where necessary
- If net redemptions exceed a “market impact threshold,” the swing factor would also include an estimate of market impact costs for each security in a MMF’s portfolio (“market impact factor”)
 - Permitted to estimate costs and the market impact factor by security type, rather than for each individual security
 - SEC noted that it would be appropriate for market impact factor for daily and weekly liquid assets to be zero because of their shorter maturities
 - As proposed, rule would increase liquidity thresholds and a substantial portion of an institutional MMF would likely be presumed to have a market impact factor of zero



MARKET IMPACT THRESHOLDS

- Defined as 4% of the fund's NAV divided by number of pricing periods in a business day
 - Market impact costs can be based on an estimate of the percentage decline in the value of each security if sold under current market conditions
 - Estimate would then be multiplied by dollar amount of the security that would be sold if a fund sold a pro rata amount of each security to meet redemptions
 - Process would then be repeated across the vertical slice
- Concerns regarding feasibility of calculating thresholds prior to determination of a fund's NAV



MARKET IMPACT THRESHOLDS (CONT.)

Figure 1: Swing Pricing Process

Step	Result
1. Did the fund have net redemptions?	No: Do not apply a swing factor Yes: Proceed to next step
2. Did the net redemptions exceed the market impact threshold?	No: Apply swing factor that includes spread costs (if the fund uses midmarket pricing) and other transaction costs of selling a vertical slice of the fund's portfolio Yes: Apply swing factor that includes spread costs (if the fund uses midmarket pricing), other transaction costs, <i>and market impact factor</i> of selling a vertical slice of the fund's portfolio



SWING PRICING – OPERATIONAL CONCERNS

- Money market fund structural issues
 - Multi-strike NAV funds
 - Same day settlement
- Use of estimates in calculating net redemptions, swing factors and market impact costs
- Role of intermediaries and service providers
- Prior industry experience with swing pricing for non-money market funds
 - US – lacking widespread adoption/infrastructure
 - Europe – timing and application differences



NEGATIVE INTEREST RATES AND CONVERSIONS TO FLOATING NAVS

- Proposal would expressly prohibit MMFs from utilizing:
 - reverse distribution mechanisms;
 - routine reverse stock splits; or
 - other devices that would periodically reduce the number of the fund's outstanding shares to maintain a stable share price
- As proposed, stable NAV MMFs would need to convert to a floating NAV if market conditions result in prolonged negative fund yields
- Rule 2a-7 already requires stable NAV MMFs to have the capacity to redeem and sell shares at prices that do not correspond to stable NAV, but proposal would require these funds to:
 - determine that intermediaries have the capacity to redeem and sell shares at a floating NAV; or
 - if not, prohibit the relevant intermediaries from purchasing their shares on behalf of other persons in nominee name.



CONVERSIONS TO FLOATING NAVS – OPERATIONAL CONCERNS

- Timing and coordination with service providers and intermediaries
- Processes and systems to handle FNAV conversions and costs relating to system enhancements
- Compliance and tracking
- Sales and distribution considerations and potential impact to MMF asset levels



REMOVAL OF FEES AND GATES

- Proposed rule removes fee and gate provisions from Rule 2a-7, which were adopted as part of 2014 reforms
- Overview of Current Rule
 - Elective 2% liquidity fee or gate if weekly liquid assets fall below 30% and Board determines that imposing a fee or gate is in fund's best interest
 - Default 1% liquidity fee if weekly liquid assets fall below 10%, unless Board finds that such fee would not be in the fund's best interest
- Unintended consequences: potential imposition of fees or gates widely believed to have contributed to shareholders redeeming from MMFs early due to the explicit relationship between a fund's liquidity levels and a board's authority to impose a fee or gate
- Rule 22c-2 and Rule 22e-3 remain available to MMFs



INCREASED LIQUIDITY REQUIREMENTS

- Proposal would increase requirements for daily liquid assets to 25% (from 10%) and weekly liquid assets to 50% (from 30%)
 - Intended to provide greater buffer for MMFs to meet redemptions
 - MMFs would be required to notify board of a “liquidity threshold event” (i.e., when a fund has invested less than 25% in weekly liquid assets or less than 12.5% in daily liquid assets)



ADDITIONAL REPORTING REQUIREMENTS

- Proposed rule would amend some reporting requirements on Forms N-CR and N-MFP, plus conforming changes to Form N-1A
- Form N-CR
 - Liquidity threshold event reporting
 - Report of purchase date of any asset that is purchased by an affiliate
- Form N-MFP
 - Increased frequency of 5% beneficial owner reporting
 - Reporting of composition of shareholders by type (FNAV MMFs)
 - Reporting number of securities sold or disposed by institutional or retail prime MMFs of during the reporting period
 - Daily liquidity, NAV and flow data for each business day of the month, rather than on a weekly basis





ESG DISCLOSURE PROPOSALS



ESG DISCLOSURE RULE PROPOSALS

- The Proposed ESG Disclosure rule promotes the use of consistent, comparable, and reliable information for investors concerning funds' and advisers' incorporation of ESG factors
- The proposed rule includes:
 - ESG-related disclosure and reporting requirements, the specificity and level of detail of which depend on the extent to which a fund considers ESG factors in its investment process
 - New fund taxonomy consisting of three categories of ESG funds, each with accompanying disclosure requirements
 - Environmentally focused funds would be required to disclose its carbon footprint and weighted average carbon intensity (WACI) in its annual shareholder report unless the fund affirmatively states that it does not consider issuers' GHG emissions as part of its investment strategy



ESG DISCLOSURE RULE PROPOSALS (CONT.)

- Proposed New ESG Taxonomy

Type of Fund	Definition
Integration Funds	Funds that “ consider ” one or more ESG factors alongside other, non-ESG factors in their investment decision-making process, but where such ESG factors are not dispositive in the funds’ investment decisions
ESG-Focused Funds	Funds that consider one or more ESG factors as significant or primary factors in selecting investments or in engagement with portfolio companies
Impact Funds	Subset of ESG-Focused Funds that seek to achieve on or more specific ESG impacts



ESG DISCLOSURE RULE PROPOSALS (CONT.)

- Proposed prospectus disclosures

Type of Fund	Disclosure Requirements
Integration Funds	<ul style="list-style-type: none"> How the fund incorporates ESG factors into investment selection processes How such ESG factors are considered alongside other factors Methodology and data sources in considering GHG emissions (if applicable)
ESG-Focused Funds	<ul style="list-style-type: none"> Standardized “ESG Strategy Overview Table” consisting of a “checkbox” format to indicate which ESG strategies the fund employs Descriptions of internal methodology or third-party data provider used in selecting investments, identification of indices the fund tracks, and the participation of the fund and its adviser in any third-party ESG frameworks
Impact Funds	<ul style="list-style-type: none"> All disclosure requirements applicable to ESG-Focused Funds ESG impact the fund seeks to generate with its investments How the fund measures progress toward the stated impact Time horizon used to measure that progress Relationship between the impact the fund is seeking to achieve and the fund’s financial returns



ESG DISCLOSURE RULE PROPOSALS (CONT.)

- Proposed annual report disclosures

Type of Fund	Disclosure Requirements
ESG-Focused Funds	<ul style="list-style-type: none">Information regarding how the fund voted proxies on particular ESG-related voting matters (if applicable)Information regarding the fund's participation in ESG engagement meetings (if applicable)Carbon footprint and WACI (if applicable)
Impact Funds	<ul style="list-style-type: none">Summary of progress towards achieving stated ESG impacts



ESG DISCLOSURE

- How to Prepare
- Overlap with Operating Company Proposal
- Potential SEC Sweep Topics





NAMES RULE PROPOSALS



PROPOSED NAMES RULE SUMMARY

- Proposed Rule 35d-1 Amendments Constitute a Sea Change and include:
 - Expanding the rule's scope to include fund names with terms suggesting that a fund focuses in investments that have - or whose issuers have – “particular characteristics”
 - This would expand the rule to apply to funds with names including terms that historically connoted a specific strategy, such as “growth,” “value,” “income,” “global,” and “international”
 - Limiting the ability of a fund to depart from its 80% policy by prescribing a limited set of circumstances and timeframes during which such a departure is permitted
 - Departure permitted only as a result of market fluctuations or other circumstances not caused by the purchase or sale of a security or entering or exiting an investment, to address unusually large cash inflows or redemptions, to take a position in cash and cash equivalents or government securities to avoid loss in response to adverse market, economic, political, or other conditions, or during certain fund events
 - “Under normal circumstances” standard would be removed
 - 30 day limit



PROPOSED NAMES RULE SUMMARY (CONT.)

- Requiring use of the notional value of derivatives instruments, rather than market value, when calculating compliance with the 80% policy
- Codifying the SEC position that no safe harbor exists for technical compliance with the rule; a name may be materially deceptive or misleading even if the fund complies with its 80% policy
 - Impact on 20% basket



EXPANSION OF SCOPE: PARTICULAR CHARACTERISTICS

The Names Rule proposal would expand its application to terms suggesting a focus on investments with “particular characteristics.”

Terms Covered by Proposed Expanded Scope of the Names Rule	Terms That Would Continue to be Excluded from the Names Rule
Growth/Value	Characteristics of a fund’s objective or portfolio as a whole (Duration, Balanced)
ESG Factors	Elements of an investment thesis or technique without specificity as to the particular characteristics of the component portfolio investments (Long/Short)
Global/International	A possible result to be achieved (Real Return)
Income	A retirement target date
Intermediate Term (or similar) Bond	



COMPLIANCE AND IMPLEMENTATION CHALLENGES

- Inventory – proposed rule will require all funds to make a Rule 35d-1 applicability determination
- Expansion – the scope of terms considered to be materially deceptive and misleading in a fund's name without an 80% policy are broadened
 - ESG “integration” fund names deemed misleading
- Monitoring – daily portfolio monitoring requirement
- Disclosure – requires additional disclosures regarding how a fund selects investments used in its name
- Limitations – the types of investments a fund can make outside of its 80% Policy will now be limited



NAMES RULE PROPOSALS

- How to Prepare – Taking Inventory and Following-Up
- Hidden Pitfalls – Valuation and Use of Derivatives
- Looking at the Calendar
- Potential SEC Sweep Topics





DISCLOSURE MODERNIZATION



DISCLOSURE MODERNIZATION

- On October 26, the SEC voted to adopt a new approach to shareholder and investor communications by registered open-end funds and exchange-traded funds
- Rule 30e-3:
 - Open-end funds are excluded from the scope of Rule 30e-3 with respect to shareholder reports. Funds are required to mail shareholder reports to all shareholders, unless a shareholder affirmatively opts-in to electronic delivery
- Advertising Amendments:
 - Presentations of investment company fees and expenses in advertisements and sales literature is required to be consistent with relevant prospectus fee table presentations and be reasonably current



DISCLOSURE MODERNIZATION (CONT.)

- Shareholder Reports:
 - Mutual funds and ETFs registered on Form N-1A required to transmit concise and visually engaging annual and semi-annual reports (3-4 pages in length) that highlight information that is particularly important for retail shareholders to assess and monitor fund investments
 - Registered funds required to make available online certain information (e.g., schedule of investments, other financial statement elements) that may be more relevant to investors and financial professionals who desire more in-depth information
 - All funds required to compare their performance to the overall applicable securities market, for purposes of both fund annual reports and prospectuses
 - In-Line XBRL Tagging Required



SEC OPEN MEETING - NOVEMBER 2 2022

- Adoption of Proxy Form Amendments
 - ESG Impacts
- Proposed Rules/Amendments re: LRMP, Swing Pricing and Other Pricing Requirements

