Session I

Regulatory Roundup - Rules Impacting Registered Investment Companies – Preparing for the Changing Environment

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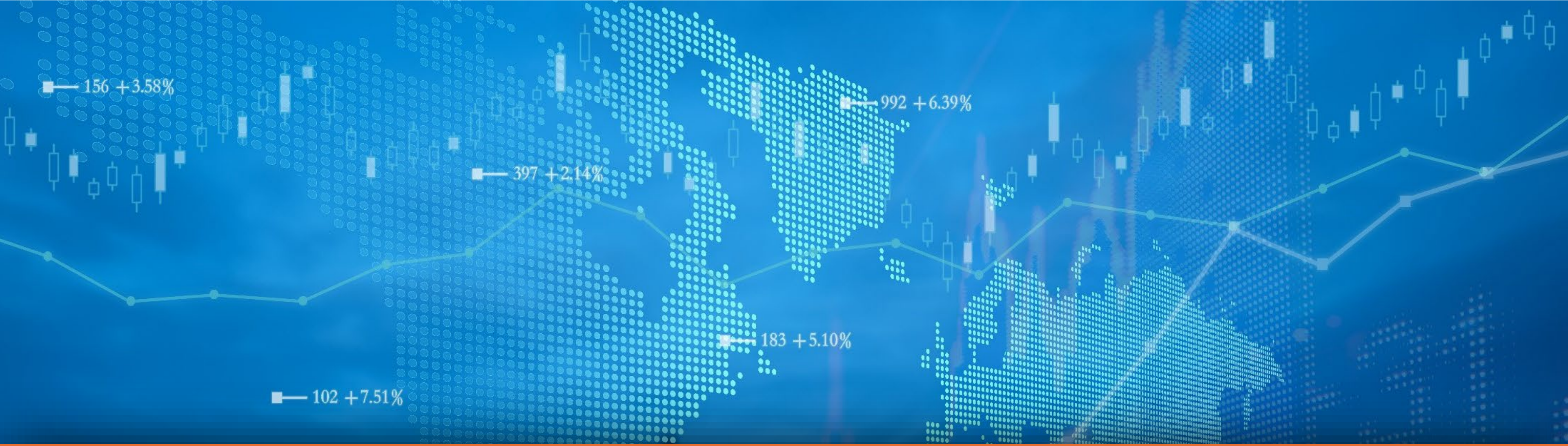


REGULATORY LANDSCAPE

REGULATORY LANDSCAPE

- SEC-registered funds and their advisers are operating in a precarious regulatory environment, with relentless enforcement activity and a stunning rulemaking agenda
- Simultaneously, the SEC and its staff have little appetite to consider offering new relief intended to further shareholder interests and novel strategies

REGULATORY LANDSCAPE

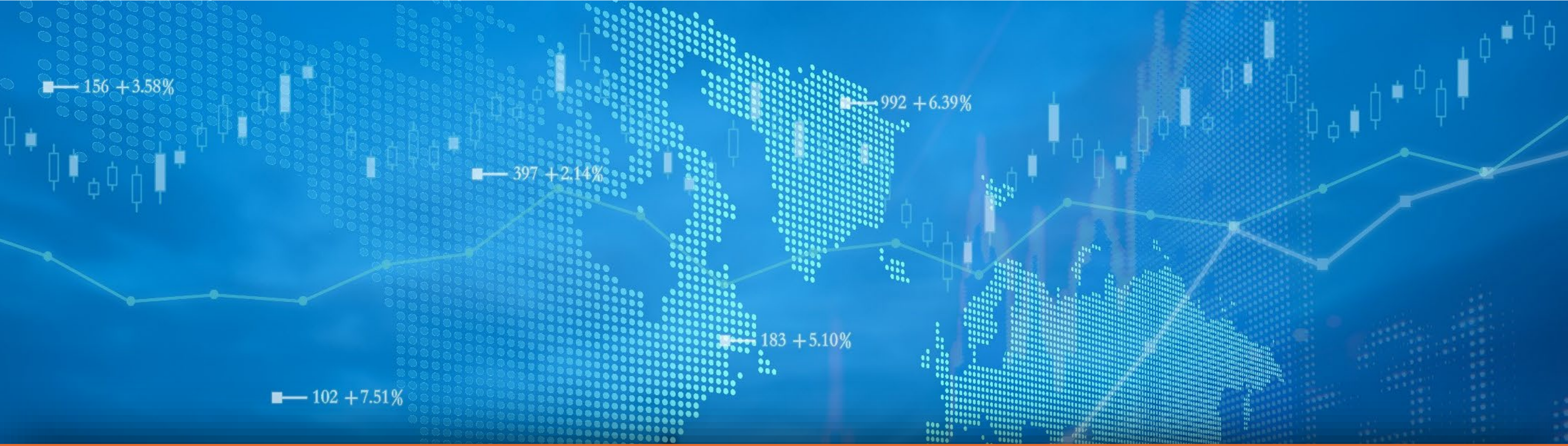
- Rulemaking
  - More than 20 new rule or form amendments proposed in the 9-month period ended September 30, 2022
  - More than 25 new rules or amendments in the “final rule” stage (as of last Agency Rule List publication)
  - On October 7, 2022, SEC announced re-opening of comment period of 12 proposed rules due to a “technological error” in receiving comment letters

REGULATORY LANDSCAPE

- Enforcement
  - SEC filed 434 new enforcement actions in the 2021 fiscal year, marking a **7% increase** over the prior year
  - SEC nearly doubled the size of the Division of Enforcement’s Crypto Assets and Cyber Unit (announced May 2022)
- Examinations
  - SEC to add an “Office of Crypto Assets and an Office of Industrial Applications and Services” to the Division of Corporation Finance's Disclosure Review Program (announced September 2022)

REGULATORY LANDSCAPE

- "[W]e go after misconduct wherever we find it in the financial system, holding individuals and companies accountable, without fear or favor…" – *SEC Chair Gary Gensler, November 18, 2021*
- "Robust enforcement requires the [SEC's] Division [of Enforcement] to be the cop on the beat and cover the entire securities waterfront, investigating and litigating every type of case within our remit with a sense of urgency." - *SEC Director of Division of Enforcement Gurbir S. Grewal, July 21, 2022*



RULES IMPACTING REGISTERED INVESTMENT COMPANIES

PROPOSED ESG DISCLOSURE REFORMS

- Proposed ESG reforms for registered funds included:
  - ESG-related disclosure and reporting requirements, the specificity and level of detail of which would 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 fund 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

PROPOSED ESG DISCLOSURE REFORMS

- 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 one or more specific ESG impacts

PROPOSED ESG DISCLOSURE REFORMS

- Proposed prospectus disclosures

Type of Fund	Disclosure Requirements
Integration Funds	▪ 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	▪ Standardized “ESG Strategy Overview Table” consisting of a “check-box” 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	▪ All disclosure requirements applicable to ESG-Focused Funds ▪ ESG impact that 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

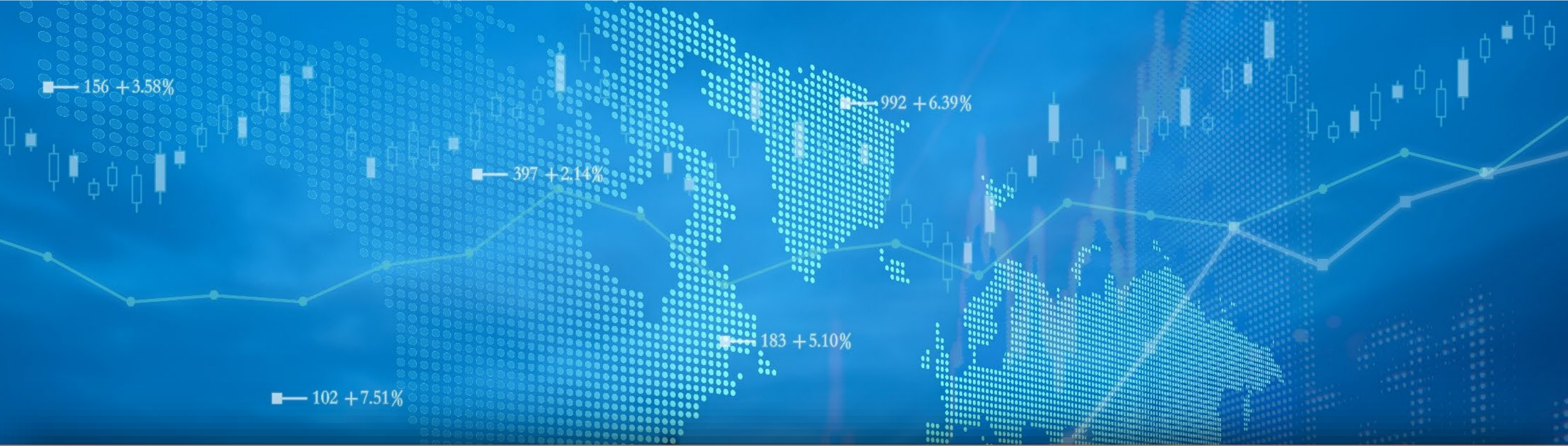
PROPOSED ESG DISCLOSURE REFORMS

- Proposed annual report disclosures

Type of Fund	Disclosure Requirements
ESG-Focused Funds	▪ 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	▪ Summary of progress towards achieving stated ESG impacts

PROPOSED ESG DISCLOSURE REFORMS

- Challenges imposed by the proposed reforms include:
  - Overly broad definitions of “Integration” and “ESG-Focused”
  - Potentially increasing risk of greenwashing and confusing investors, at no fault of the funds
  - Reliance on third parties and “best estimates” for GHG emissions disclosures present risk of private litigation
  - Emphasis on quantity of engagement meetings and fund-level disclosures
  - Special considerations for funds-of-funds and multi-manager funds



EU: Sustainable Finance Disclosure Regulation (SFDR)
UK: Sustainable Disclosure Requirements (SDR)

KEY THEMES – GLOBAL SUSTAINABLE FINANCE DISCLOSURE REGULATION

- **Lack of consistent and comparable information**
  - No common definitions/philosophies of “sustainable finance” or “ESG”
  - Lack of comparable metrics/methodology

- **Knowledge gaps**
  - Preference for sustainable investments may not marry up with financial literacy, especially for retail investors

- **Perceptions of performance and risk**
  - Difficulty comparing sustainable products and conventional investment products

- **Connecting investors with sustainable products**
  - Key role for asset managers and financial advisors
  - Importance of financial education for industry participants, especially financial advisors

DIVERGING PHILOSOPHIES AND APPROACHES TO DISCLOSURE REGIMES

US	EU	UK
The proposed SEC regime **does not seek to actively promote sustainability.** Instead, it is focused on rooting out greenwashing. For example, the SEC's proposed expansion to the names rules, in order to prevent the misuse of ESG orientated fund names.	The EU has focused on **actively encouraging sustainable investment** and attracting capital into ESG funds. Under what has become a de facto labelling regime, Articles 8 and 9 are now considered 'badges of ESG-ness'.	The proposed UK regime is focused on **sustainable investment labels and is intended to be consumer-facing.** Emphasis has been placed on helping retail investors to navigate the market for ESG investment products. A general 'anti-greenwashing' rule is also being consulted on currently **(CP22/20).**

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EU SFDR and Taxonomy Regulation – A recent timeline

10 March 2021

SFDR

- Key disclosures become applicable at both entity and product level.
- (Level 1 only)

30 June 2021

SFDR

- Principle Adverse Impacts (PAI) disclosure requirements for larger participants and required website disclosure
- (Article 4(3) and Article 4(4) SFDR).

1 January 2022

SFDR

- Periodic Reporting
- (Article 11 SFDR)

Taxonomy Regulation

- (Level 1 only)
- The Taxonomy Climate Delegated Act, containing Techinical Screening Criterea (TSC) in relation to two of the environmental objectives applies.

2 August 2022

- Application of sustainability-related provisions under MiFID II & IDD.

30 December 2022

SFDR

PAI at product level, review disclosures (Article 7 SFDR). Only applicable if a financial market participant (FMP) has opted to consider adverse sustainability impacts (under Article 4 SFDR).

1 January 2023

SFDR RTS

Regulatory Technical Standards (RTS) developed under the SFDR apply.

1 January 2023

Taxonomy Regulation

- TR disclosures relating to all environmental objectives (under Articles 5 and 6) start to apply.
- TR disclosures for non-financial undertakings relating to taxonomy-alignment start to apply.

ACTIVE MARKETING OF ESG FUNDS

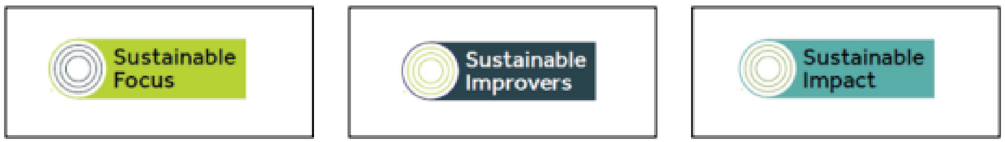
- **‘Article 8’ Funds** – Funds that “promote, among other characteristics, environmental or social characteristics (or a combination of these) and the investee companies follow good governance practices.” Also known as “E/S Funds.”
- **‘Article 9’ Funds** – Funds that have “sustainable investment as their objective.” Also known as “ESG Funds.”

UK SDR UPDATE – FCA CONSULTATION PAPER 22/20

FCA proposals in **CP22/20** cover the following **main areas:**

- Anti-greenwashing rule
- Sustainable investment product labels:
  - **“Sustainable Focus”**
  - **“Sustainable Improvers”**
  - **“Sustainable Impact”**
- Consumer-facing product-level disclosures
- Detailed disclosures
- Naming and marketing rules
- Requirements for distributors (such as investment platforms)

Figure 4 – Sustainable investment labels



SDR and investment labels (CP22/20) – Next Steps

25 October 2022

- CP22/20 published.

25 January 2022

- Consultation period ends

*30 June 2023

- Provisional date for finalisation of rules / PS.
- General anti-greenwashing requirement effective immediately on the publication of the PS.

*30 June 2024

- Labelling, naming and marketing, consumer-facing and pre-contractual disclosure requirements – and rules for distributors – will become effective 12 months after publication of the PS.

*30 June 2025

- The first ongoing sustainability performance-related disclosures must be published 24 months after publication of the PS.
- Entity-level disclosures in the sustainability entity report will have a staggered implementation, with the largest firms producing their first disclosures 24 months after publication of the PS.

** These dates are **provisional only** and are set by reference to the publication date of the policy statement in 2023 **(CP22/20).***

ACTIVE MARKETING OF ESG FUNDS / 'ESG BADGES'

EU:
- **'Article 8' Funds**
- **'Article 9' Funds**

US:
- **Integration Funds**
- **ESG-Focused Funds**
- **Impact Funds**

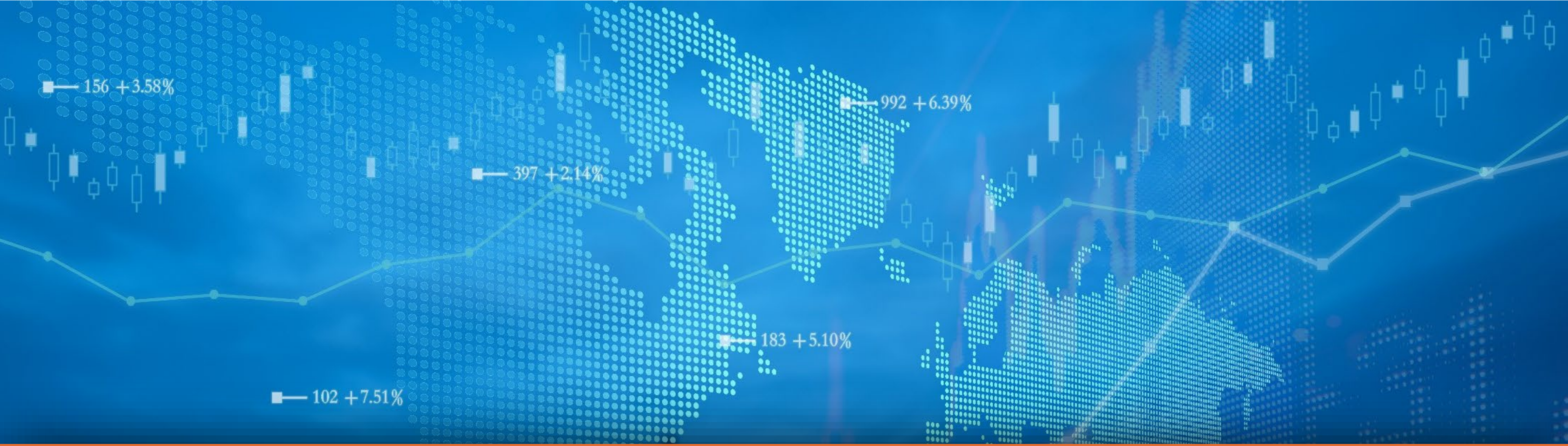
UK:
- **'Sustainable Focus' Fund**
- **'Sustainable Improver' Funds**
- **'Sustainable Impact' Funds**

KEY TAKEAWAYS

- Global asset managers marketing products across jurisdictions will have to grapple with ***differentiated***, rather than harmonised disclosures

- Differences between disclosure regimes are underpinned by diverging philosophies on whether regulators should be actively promoting sustainable investment, or safeguarding against ‘greenwashing’

- Challenges lie ahead in ensuring that funds marketed globally remain true to their own ESG strategies, rather than being dictated by regulatory intervention and the desire to market as a certain category



RULES IMPACTING REGISTERED INVESTMENT COMPANIES

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PROPOSED NAMES RULE REFORMS

- Section 35(d) of the Investment Company Act prohibits a registered investment company from adopting as part of its name or title any word that the SEC finds to be materially deceptive or misleading
- Rule 35d-1 (the so-called "names rule"), adopted in 2001, deems certain types of names to be materially deceptive or misleading for purposes of Section 35(d), and requires, in part, that a fund with a name suggesting investment in a particular type of *investment, industry, country or geographic region* must adopt a policy to invest, "***under normal circumstances***", at least 80% of its assets in that type of investment, industry, country or geographic region (80% Investment Policy)
  - Terms generally referring to strategies, such as "growth" and "value", as well as "global" and "international" are not covered by the names rule
  - In response to SEC staff comments, many funds with ESG-related terms in their names assert that such terms refer to strategies rather than a "type of investment", and are therefore outside the scope of the names rule
  - Reference to "under normal circumstances" permits necessary flexibility to account for market dislocations and other unusual events

PROPOSED NAMES RULE REFORMS

- Proposed amendments to Rule 35d-1 would significantly expand the 80% Investment Policy to include terms previously outside of the rule's reach and otherwise impose burdensome restrictions, including by:
  - 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% Investment Policy by prescribing a limited set of circumstances and timeframes during which such a departure is permitted
    - "Under normal circumstances" standard would be removed
    - 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
    - The fund would need to return to compliance with its 80% investment policy as soon as reasonably practicable and no later than within 30 days (other than in certain limited circumstances)

PROPOSED NAMES RULE REFORMS

- Requiring use of the notional value of derivatives instruments, rather than market value, when calculating compliance with the 80% investment 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% investment policy
  - Impact on 20% basket
  - Name could still be materially deceptive or misleading for purposes of section 35(d) if a fund complies with its 80% investment policy but makes a substantial investment that is “antithetical” to the fund’s investment focus

PROPOSED NAMES RULE REFORMS

- Challenges imposed by the proposed names rule reforms include:
  - Term “particular characteristics” is vague and subject to inconsistent interpretation and application
  - Terms such as “growth,” “value,” “income,” “global,” “international,” and “intermediate term bond,” and terms indicating that a fund’s investment decisions incorporate one or more ESG factors, which would all be subject to the rule, are inherently subjective and not easily subjected to an asset-based test
  - Risk of forced selling at inopportune times and potential volatility
  - Index funds and rebalancing
  - Evaluating whether an investment is “antithetical” to a fund’s name is highly subjective
  - Notional value of certain derivatives instruments may not accurately represent the exposure a fund obtains through derivatives and may lead to skewed compliance results
  - Considerations for multi-manager funds and index funds upon rebalancing

PROPOSED FUND DISCLOSURE FRAMEWORK REFORMS

- Proposed in August 2020
- **Streamlined shareholder report** (as few as 3 pages), with key information in a prescribed order, would serve as the primary fund disclosure document for existing shareholders; delivered twice per year, together with notice of material fund changes
- Prospectus would still have to be delivered for initial investments in the fund, but annually updated prospectus and traditional shareholder reports would be delivered only upon request
- Funds would no longer be able to rely on Rule 30e-3 (e-delivery for reports)
- Most of the "less retail-focused" information currently contained in prospectuses and shareholder reports would be moved to fund websites and Form N-CSR
- Current fee table in the summary prospectus would be moved to statutory section and replaced with a simplified fee summary
- Principal risks in prospectus would be limited to those that satisfy a new "10% standard" - and listed in order of importance
- Fund advertisements and sales literature would be required to present fees consistently with streamlined shareholder reports

ADOPTED FUND DISCLOSURE FRAMEWORK REFORMS

- Adopted on October 26, 2022
- Key Aspects of Final Rules:
  - **Rule 30e-3.** Open-end funds excluded from the scope of Rule 30e-3 with respect to shareholder reports - required to mail shareholder reports to all shareholders, unless a shareholder affirmatively opts-in to electronic delivery
  - **Shareholder Reports**
    - *Fund and Class Specific Reports:* Multi-class funds can no longer prepare a single shareholder report and a fund family can no longer include multiple series in a single report
    - *Concise and Visually Engaging 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, including:
      - Simplified expense presentation;
      - Streamlined discussion of fund performance;
      - "Fund Statistics;"
      - Graphical representation of fund holdings; and
      - Disclosure regarding "material changes"

ADOPTED FUND DISCLOSURE FRAMEWORK REFORMS

- Key Aspects of Final Rules, continued:
    - *Layered Disclosure:*
        - 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
    - *Definition of "Broad-Based Securities Market Index":*
        - 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*
- **Advertising Amendments.** Presentations of investment company fees and expenses in advertisements and sales literature *required* to be consistent with relevant prospectus fee table presentations and be reasonably current

ADOPTED FUND DISCLOSURE FRAMEWORK REFORMS

- Key Aspects of Proposed Rules ***Not*** Adopted:
  - Division of disclosures for current vs. prospective shareholders
  - Registration statement risk disclosures (10% threshold for inclusion of risk disclosure/ordering of risks)
  - Proposed Rule 498B
    - Prospectuses will continue to be transmitted to existing shareholders in the usual manner
  - Proposed rule amendments regarding acquired fund fees and expenses
- Effective & Compliance Dates:
  - **Effective Date**: Final rule amendments effective 60 days after publication in the Federal Register
  - **Shareholder Report/Rule 30e-3 Transition Period**: 18-month transition period after the effective date of the final rule amendments to allow open-end funds adequate time to adjust their shareholder reports and comply with the Rule 30e-3 changes
  - **Advertising Rule Transition Period**: 18-month transition period after the effective date to comply with the final rule amendments to the advertising rules
    - *Note*: Final rule amendments that address representations of fees and expenses that could be materially misleading apply on the effective date

PROPOSED CYBERSECURITY RISK MANAGEMENT RULES APPLICABLE TO FUNDS

- Proposed on February 9, 2022
- **Policies and Procedures.** Advisers and registered funds to adopt and implement written policies and procedures, including specific enumerated elements, reasonably designed to address cybersecurity risks
  - As proposed, “cybersecurity risk” is defined as the “financial, operational, legal, reputational, and other adverse consequences that could stem from cybersecurity incidents, threats, and vulnerabilities”
- **Reporting.** Advisers to report certain cybersecurity incidents to the SEC on new Form ADV-C within 48 hours, including on behalf of any registered funds or private funds that experience such incidents
- **Disclosure.** Advisers and registered funds to disclose cybersecurity risks and incidents in their disclosure documents
- Amendments to certain recordkeeping rules would obligate registered funds to maintain for five years copies of policies, reports of annual reviews, incident records, and risk assessments

PROPOSED CYBERSECURITY RISK MANAGEMENT RULES APPLICABLE TO FUNDS

- Challenges imposed by the proposed rules include:
  - Increasing the burden, and potentially the liability, for registered funds, particularly when overseeing and contracting with service providers
  - Imposing an explicit and substantial duty on registered funds to address risks directly faced by their service providers' systems and activities, which, in the event of a cybersecurity incident affecting such a service provider, could impact a registered fund
  - Requiring registered fund boards to consider the appropriate level of board oversight and review of these service provider cybersecurity concerns

PROPOSED MONEY MARKET FUND REFORMS

- Proposed on December 15, 2021
- On October 7, 2022, SEC announced re-opening of comment period due to "technological error" in receiving comment letters
- Proposal is the latest attempt by the SEC to reform the rule governing money market funds (MMFs) (Rule 2a-7) in response to concerns raised by the market conditions and liquidity constraints experienced by MMFs in 2020 in the wake of COVID-19
- These issues are largely addressed by the proposal:
  - Removal of liquidity fees and redemption gates requirements;
  - Increased requirements for portfolio liquidity (greater "buffer" to meet redemptions); and
  - Mandatory swing pricing requirements – intended to result in redeeming investors bearing the liquidity costs of their redemptions

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PROPOSED MONEY MARKET FUND REFORMS

- 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"
- 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
- 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 threshold (*i.e.*, a swing threshold)

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PROPOSED MONEY MARKET FUND REFORMS

- Industry commenters, in general, strongly oppose swing pricing, noting that the proposed swing pricing approach may:
  - remove the ability of MMFs to offer multi strike NAVs and same day settlement as a result of operational complexity;
  - create new market timing opportunities and have the effect of diluting remaining shareholders;
  - reduce the number of MMFs offered and the appeal for investors;
  - result in miscalculating estimates of net redemptions and errors in NAV pricing; and
  - impose substantial costs on fund sponsors that would likely decrease yields for investors
- State Street and Blackrock argued that swing pricing is inapplicable to MMFs because they do not typically finance redemptions by liquidating assets

PROPOSED MONEY MARKET FUND REFORMS

- SEC also proposes to amend Rule 2a-7 to 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
- Rather, as proposed, stable NAV MMFs may need to convert to a floating NAV if market conditions result in prolonged negative fund yields
- Although the Rule already requires stable NAV MMFs to have the capacity to redeem and sell shares at prices that do not correspond to stable NAV, the proposed rule 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

PROPOSED MONEY MARKET FUND REFORMS

- Industry commenters, in general, oppose requiring conversions of stable NAV MMFs to floating NAVs in negative interest rate environments
- Several comment letters, in relevant part:
  - support a reverse distribution mechanism as the most appropriate means to manage MMFs in a negative interest rate environment;
  - indicate that transitioning to a floating NAV could be even more complex and confusing for investors than a reverse distribution mechanism;
  - take the position that MMFs should not be required to determine that financial intermediaries can support floating NAVs; and
  - observe that the proposed approach to addressing negative interest rate environments eliminates board discretion to use its business judgment and determine what is in the best interest of shareholders
- One fund complex agrees with the SEC's desire to ensure that MMFs are capable of converting to floating NAVs in periods of sustained negative interest rates and another supports the conversion

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PROPOSED RULE FOR SEC-REGISTERED INVESTMENT ADVISERS OUTSOURCING SERVICES

- Proposed on October 26, 2022
- Comment Period: Until 30 days after the date of publication in the Federal Register or December 27, 2022, whichever is later
- Key Aspects of Proposal
  - **Outsourcing "Covered Functions."** Proposed Rule 206(4)-11 would prohibit SEC-registered investment advisers from outsourcing certain "covered functions" to service providers unless certain requirements are met
    - **Definition of "Covered Functions:"** Functions or services that: (1) are necessary to provide advisory services in compliance with the federal securities laws; and (2) if not performed or performed negligently, would reasonably be likely to cause a material negative impact on the adviser's clients or on the adviser's ability to provide investment advisory services. "Covered Functions" do not include clerical, ministerial, utility, and general office functions or services

PROPOSED RULE FOR SEC-REGISTERED INVESTMENT ADVISERS OUTSOURCING SERVICES

- Key Aspects of Proposal, continued
  - **Due Diligence**. Before retaining a service provider to perform a “covered function,” an adviser would be required to reasonably identify and determine through due diligence that outsourcing the “covered function” would be appropriate, taking into account the following factors:
    - Nature and scope of “covered function;”
    - Potential risks resulting from performance of the “covered function,” by the service provider;
    - The service provider’s competence, capacity, and resources necessary to perform the “covered function;”
    - The service provider’s material subcontracting arrangements related to the “covered function;”
    - Coordination with the service provider for federal securities law compliance; and
    - The orderly termination of the performance of the “covered function”
  - **Monitoring**. Adviser would be required to monitor a service provider’s performance and reassess the selection of the service provider to perform the covered function. Adviser would also be required to create and maintain books and records relating to its due diligence and monitoring activities

PROPOSED RULE FOR SEC-REGISTERED INVESTMENT ADVISERS OUTSOURCING SERVICES

- Key Aspects of Proposal, continued
  - **Oversight of Third Party Recordkeepers**. Proposed Rule 206(4)-11 would require advisers that rely on third-party recordkeepers to conduct due diligence and monitoring of that third party as if the third party were a "service provider" performing a "covered function" as defined by the proposed rule. In addition, advisers would be required to obtain "reasonable assurances" that the recordkeeper will meet the following four standards (conditions) that the SEC believes are specific to recordkeeping:
    - Adopt and implement internal processes and/or systems for making and/or keeping records that meet the requirements of the recordkeeping rule applicable to the books and records being maintained on behalf of the adviser;
    - Make and/or keep records that meet all of the requirements of the recordkeeping rule applicable to the adviser;
    - Provide access to electronic records; and
    - Ensure the continued availability of records if the third party's relationship with the adviser or its operations cease

FAIR VALUATION DETERMINATIONS UNDER RULE 2a-5

- Compliance date was September 8, 2022
- 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)
- Under Rule 2a-5(a), determining fair value in good faith requires:
  - (i) periodically assessing and managing material risks associated with fair value determinations;
  - (ii) establishing and applying fair value methodologies (*i.e.*, selecting and applying consistently, periodically reviewing appropriateness and accuracy, and monitoring for need to use);
  - (iii) testing fair value methodologies; and
  - (iv) overseeing and evaluating any pricing services used

FAIR VALUATION DETERMINATIONS UNDER RULE 2a-5

- The board must determine fair value as set forth in Rule 2a-5(a) or, pursuant to Rule 2a-5(b), it may designate a "Valuation Designee" to perform the fair value determinations relating to any or all fund investments, *subject to the board's oversight*
- The board remains responsible for fair value determinations under Section 2(a)(41), but may fulfill its statutory obligation through active oversight of Valuation Designee
- Valuation Designee may be a fund's primary investment adviser or an officer of the fund, but it may not be a fund's sub-adviser or administrator
- Boards and investment advisers may continue to use other parties, such as pricing services and fund sub-advisers and administrators, to *assist* in performing fair valuation determinations
- Valuation Designee must specify the titles of the persons responsible for determining fair value, including by specifying the particular functions for which they are responsible, and reasonably segregate fair value determinations from the portfolio management of the fund

FAIR VALUATION DETERMINATIONS UNDER RULE 2a-5

- The Valuation Designee must report to the board, in writing, such information as may be reasonably necessary for the board to evaluate the matters covered in the following required reporting
- **Quarterly Reporting**. Each quarter, the Valuation Designee must provide:
  - Any reports or materials requested by the board related to fair value of investments or Valuation Designee's process for fair valuing fund investments; and
  - A summary or description of material fair value matters that occurred during the prior quarter, including:
    - Any material changes in the assessment and management of material valuation risks, including conflicts of interest of Valuation Designee or any service provider;
    - Any material changes to, or deviations from, established fair valuation methodologies; and
    - Any material changes to Valuation Designee's process for selecting and overseeing pricing services and material events related to its oversight of pricing services

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FAIR VALUATION DETERMINATIONS UNDER RULE 2a-5

- 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
- New areas to be covered for some funds, depending on current practices, include assessment and management of material valuation risks, testing of fair values, and oversight of pricing services

FAIR VALUATION DETERMINATIONS UNDER RULE 2a-5

- **Annual Reporting**. Valuation Designee must provide an assessment of the adequacy and effectiveness of its process for determining fair value of portfolio investments, including summary of methodology testing results and an assessment of the adequacy of resources dedicated to the process and any material changes to the roles or functions of those involved
- **Prompt Reporting**. Valuation Designee must promptly (within a time period determined by the board, and in any case, no later than 5 business days after Valuation Designee becomes aware of the matter) notify the board on matters that materially affect the fair value of portfolio investments (*e.g.*, significant deficiency or weakness in process design or effectiveness detected; material calculation error), with follow-up reporting as determined by the board

USE OF DERIVATIVES UNDER RULE 18f-4

- Rule 18f-4 represents a comprehensive re-working of the regulation of derivatives, which was previously comprised of a patchwork of guidance
- 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
- Compliance date was August 19, 2022
- Prior SEC releases and staff guidance were rescinded on August 19, 2022

USE OF DERIVATIVES UNDER RULE 18f-4

- Funds generally must limit their leverage risk based on a fund's "Value at Risk" or "VaR," using either a relative or absolute test
- Fund may choose any VaR model that meets the conditions set forth in the rule
- Relative VaR Test -- Fund VaR may not exceed 200% of an unleveraged "designated reference portfolio"
  - May use an index or fund's own portfolio as the reference portfolio
  - A fund must apply the relative VaR test unless the derivatives risk manager (DRM) reasonably determines that a designated reference portfolio would not provide an appropriate comparison
- Absolute VaR Test -- Fund VaR may not exceed 20% of NAV

USE OF DERIVATIVES UNDER RULE 18f-4

- Derivatives Risk Management Program (DRMP) - Written program with policies and procedures reasonably designed to manage the fund's derivatives risks
- Administered by DRM, who is approved by the board
- DRMP must include designated components, tailored to a fund's use of derivatives:
  - Risk identification and assessment
  - Risk guidelines
  - Stress testing
  - Backtesting
  - Internal reporting and escalation of material risks
  - Periodic review
- Rule allows funds to involve sub-advisers in derivatives risk management, including sub-adviser personnel serving in certain cases as the DRM or as part of a DRM group, or otherwise providing information and assisting with required assessments, monitoring and reporting

USE OF DERIVATIVES UNDER RULE 18f-4

- Board, including majority of independent members, must approve the DRM
- DRM must provide a number of different reports to the board:
  - Report upon/before implementation, and at least annually, including:
    - Representation that the DRMP is reasonably designed to manage derivatives risks and to incorporate Rule 18f-4 requirements, and the basis therefor
    - Effectiveness of the DRMP's implementation
    - Basis for determinations regarding designated reference portfolios
  - Regular reports (with frequency determined by the board) of DRM's analysis of exceedances of guidelines, stress testing and backtesting
  - Additional reporting required if a fund exceeds VaR test for more than 5 business days

USE OF DERIVATIVES UNDER RULE 18f-4

- A fund is exempt from VaR testing, DRMP and board oversight and reporting requirements if:
  - It adopts and implements written policies and procedures reasonably designed to manage derivatives risk; and
  - Its derivatives exposure does not exceed 10% of the fund’s net assets, generally excluding:
    - Derivatives for hedging an investment’s interest rate or currency risks
    - Borrowings
    - Closed-out positions that were closed with the same counterparty
- If a fund exceeds this exposure for more than 5 business days, adviser must promptly report to the board whether:
  - The fund will reduce the exposure below 10% within 30 days; or
  - The fund will comply with the other Rule 18f-4 requirements as soon as reasonably practicable

USE OF DERIVATIVES UNDER RULE 18f-4

- Shortly after the compliance date, SEC staff began conducting 18f-4 exams
- The requested materials, included, in summary:
  - Written policies and procedures comprising the fund's DRMP or as a limited derivatives user
  - Any changes that were made to the DRMP during the examination period (Feb. 28, 2021 – Aug. 31, 2022), including any policies guiding any changes to the VaR and stress testing models, internal thresholds applied to VaR, stress tests and other risk metrics, and any backtesting procedures and thresholds
  - A description and frequency of the fund's stress testing and backtesting under its DRMP, including results
  - All records documenting the escalation of material risks arising from the fund's derivatives transactions, including risks identified by the fund exceeding a criterion, metric or threshold provided for by the DRMP or by stress testing

USE OF DERIVATIVES UNDER RULE 18f-4

- Documentation of the determination of the VaR of the fund's portfolio, VaR of the designated reference portfolio and value of the VaR ratio
- Information regarding consideration of "fat tails" in the VaR model
- Materials and written reports provided to the fund's board that address the operation of the DRMP, including those relating to or in connection with:
  - The board's approval of the designation of the DRM
  - The fund's non-compliance with VaR testing
  - With respect to limited derivatives users, written reports when the fund's derivatives exposure exceeded 10% of net assets for longer than five business days

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