SEC STAFF NO-ACTION LETTER EASES BOARD'S BURDEN IN REVIEWING AFFILIATED TRANSACTIONS

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Investment Management Alert

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On October 12, 2018, the staff of the Division of Investment Management ("Staff") of the U.S. Securities and Exchange Commission ("SEC") issued a no-action letter to the Independent Directors Council ("IDC") ("IDC Letter") making it easier for fund boards to oversee affiliated transactions, such as cross-trades between funds managed by the same investment adviser. In the IDC Letter, the SEC stated that it would not recommend enforcement action for violations of Sections 10(f), 17(a), or 17(e) of the Investment Company Act of 1940, as amended (the "Act") if a fund board receives from the fund's chief compliance officer ("CCO"), no less frequently than quarterly, a written representation that any transactions effected in reliance on Rules 10f-3, 17a-7, or 17e-1 under the Act ("Affiliate Exemptive Rules") complied with procedures adopted by the board pursuant to the relevant Affiliate Exemptive Rule, rather than the board itself making such compliance determinations and reviewing affiliated transaction details on a quarterly basis [1]. The letter appears to be an outgrowth of a recent board outreach initiative by regulators that aims to review and reevaluate fund directors' responsibilities under the federal securities laws.

Sections 10(f), 17(a), and 17(e) of the Act prohibit registered investment companies from engaging in certain transactions with affiliates. However, the SEC has adopted the Affiliate Exemptive Rules over the years to permit certain affiliated transactions, provided that a fund's board, including a majority of its independent directors [2]: (1) adopts, and amends as necessary, procedures that are reasonably designed to provide that the transactions comply with the requirements of the pertinent Affiliate Exemptive Rule; and (2) determines at least quarterly that the affiliated transactions made pursuant to the Affiliate Exemptive Rule during the preceding quarter complied with the relevant procedures adopted by the board [3].

In granting the no-action relief, the Staff acknowledged that since the adoption of the Affiliate Exemptive Rules, the SEC has adopted Rule 38a-1, which requires funds to adopt and implement written compliance policies and procedures reasonably designed to prevent violations of federal securities laws and regulations, including the Affiliate Exemptive Rules [4]. Rule 38a-1 also requires boards to approve the designation of a CCO who will be responsible for administering such policies and procedures [5].

The Staff recognized the considerable responsibilities placed on directors as well as the prominent role of CCOs in handling the administrative aspects of a fund's compliance program. As a result, the Staff agreed with the IDC's reasoning that reviewing affiliated transactions to determine compliance with fund policies and procedures is more appropriately a CCO function, and this framework would be consistent with the SEC's policy underlying Rule 38a-1. The Staff stated that allowing a board to rely on the written representation of the CCO rather than making its

own determinations “would not change the board's oversight role with respect to a fund's overall compliance program.” Instead, it would allow directors to devote greater attention to “conflict of interest concerns” and whether engaging in affiliated transactions “is in the best interest of that fund and its shareholders,” rather than focusing on the day-to-day administrative features of a fund's compliance program.

Notwithstanding Chair Jay Clayton's recent statements “that all staff statements [including no-action letters] are nonbinding and create no enforceable legal rights or obligations of the [SEC] or other parties [6]” and the statement in the IDC Letter clarifying that the “letter is not a rule, regulation or statement of the Commission, and the Commission has neither approved nor disapproved its content,” we do expect funds and their boards will begin to rely on the letter and receive quarterly written representations from the CCO regarding compliance with the procedures adopted pursuant to the Affiliate Exemptive Rules in lieu of the board making quarterly determinations regarding compliance [7]. Fund boards and CCOs that plan to rely on the IDC Letter should review existing fund procedures relating to the Affiliate Exemptive Rules to reflect the facts and conditions in the no-action letter. The IDC's incoming letter notes that the CCO's representation could be a part of the quarterly written report that many CCOs already provide to boards or could be a standalone document. Boards and their counsel should consider the appropriate details that will be included in the CCO's representation, such as the types and number of transactions effected in reliance on each Affiliate Exemptive Rule during the quarter.

REVISITING ADDITIONAL DIRECTOR DUTIES UNDER THE ACT

The no-action relief may signal further guidance from the SEC or the Staff on fund boards' obligations under the Act and how they discharge those obligations. In October 2017, the IDC sent a letter to Dalia Blass, Director of the Division of Investment Management, highlighting the need to review fund directors' responsibilities and recommending several revisions to specific director dutiesc[8]. The recommendations related to reassessing director responsibilities and governance requirements to address changes and developments in the industry, as well as eliminating “ritualistic requirements” that duplicate the work of the CCO [9].

Over the last year, Director Blass and the Staff have engaged in a “Board Outreach Initiative,” meeting with fund boards, counsel, and auditors in the industry to consider any regulatory changes that would improve the ability of fund boards to serve shareholders [10]. The IDC Letter appears to be a positive result of this outreach effort.

Other areas of director responsibility that the IDC recommended in its October 2017 letter that the Staff reevaluate or bring to the attention of the SEC included:

- Adopting a rule permitting boards to delegate to the fund's adviser the responsibility to determine fair value of securities, subject to the board's oversight;
- Modernizing board responsibilities under Rule 12b-1 of the Act, such as the requirement that boards review Rule 12b-1 payments on a quarterly basis and reconsidering the relevance of factors listed in the Rule 12b-1 adopting release that boards should consider in determining whether to renew a distribution plan;
- Relieving boards of their responsibility under Rule 5b-3 to determine that each issuer of securities serving as collateral in certain repurchase agreements is able to meet its financial obligations and that the securities are sufficiently liquid;

- Modernizing Rule 17f-5 to allow directors to serve in an oversight role, rather than "be involved in the minutiae associated with the regular placement of foreign assets" [11];
- Eliminating the board approval requirement for fidelity bonds pursuant to Rule 17g-1, except in the case of joint bonds where there is potential for conflicts of interest among the insureds;
- Revising the requirement under Rule 18f-3 that boards make certain determinations in connection with expense allocation, so that fund accountants and fund administrators make such determinations rather than the board;
- Allowing fund service providers to set the time for computing a fund's net asset value pursuant to Rule 22c-1, rather than requiring boards to do so;
- Adopting a rule allowing a fund to be exempted from the in-person meeting requirements of the Act if an unforeseen circumstance arises, so long as certain conditions are satisfied; and
- Adopting an exemptive rule allowing directors to be considered "independent" if they hold only a nonmaterial or *de minimis* interest in a fund's unaffiliated subadvisers or their parent companies.

While it remains to be seen what further actions the Staff will take as it reassesses fund director responsibilities, the IDC Letter is a positive first step toward focusing the role of fund boards for the benefit of fund shareholders in a way that helps to clarify the board's oversight role versus the role of fund management.

NOTES

[1] *Independent Directors Council* (pub. avail. Oct. 12, 2018), https://www.sec.gov/divisions/investment/noaction/2018/independent-directors-council-101218.htm.

[2] Independent directors are directors who are not considered "interested persons" as that term is defined under Section 2(a)(19) of the Act.

[3] Subject to certain conditions, Rule 10f-3 exempts from the prohibitions of Section 10(f) purchases of securities by a fund from an affiliated underwriter in a securities offering; Rule 17a-7 exempts from the prohibitions of Section 17(a) cross-trades between affiliated funds and between fund and nonfund accounts affiliated solely by reason of having a common investment adviser; and Rule 17e-1 outlines the circumstances in which a commission, fee, or other remuneration received from a fund by an affiliated broker or an affiliate of an affiliated broker is "usual and customary" as required by Section 17(e).

[4] Rule 38a-1(a)(1).

[5] Rule 38a-1(a)(4).

[6] Jay Clayton, Chairman, SEC, Statements Regarding SEC Staff Views (Sept. 13, 2018), https://www.sec.gov/news/public-statement/statement-clayton-091318.

[7] We note that the IDC Letter goes further than the letter previously issued to the IDC and Mutual Fund Directors Forum in 2010. The 2010 letter stated that fund boards must continue to make the quarterly determinations required by the Affiliate Exemptive Rules, although it acknowledged that such determinations could be made in

reliance on summary reports from the CCO or other designated persons. Letter from Michael S. Didiuk, Attorney-Adviser, Division of Investment Management, SEC, to Dorothy A. Berry, Independent Directors Council and Jameson A. Baxter, Mutual Fund Directors Forum (Nov. 2, 2010). The IDC Letter clarifies that the no-enforcement position in the letter may be relied upon notwithstanding any inconsistent statements in the 2010 letter.

[8] Letter from Amy B.R. Lancellotta, Managing Director, IDC, to Dalia Blass, Director, Division of Investment Management, SEC, Modernizing Fund Directors' Responsibilities (Oct. 16, 2017), https://www.idc.org/pdf/30912a.pdf.

[9] *Id.* at Appendix B.

[10] *See* Dalia Blass, Director, SEC Division of Investment Management, Keynote Address at the Investment Company Institute 2018 Mutual Funds and Investment Management Conference (Mar. 19, 2018), https://www.sec.gov/news/speech/speech-blass-2018-03-19.

[11] Lancellotta, *supra* note 8, at Appendix B.

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