

# Section 17 Affiliate Transactions

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# Our Current Understanding...



# What is the Investment Company Act of 1940?

- › Legislation designed to curb abuses and deficiencies in the operation of registered investment companies (RICs) (most commonly, Mutual Fund)
  - Embezzlement
  - Fraud
  - Improper use of Mutual Fund assets
  - Self dealing
- › Imposes requirements regarding the custody of assets, investment activities, and transactions with affiliates

# What is the Purpose of §17?

- › §17, Transactions of Certain Affiliated Persons and Underwriters, is at the heart of the Act's regulatory structure
- › Protect public investors from the abuse of insider "self dealings"
- › "Self Dealing" encompasses transactions between, or involving, the Mutual Fund's assets and persons affiliated with the Mutual Fund
- › Prevent insiders from using a Mutual Fund to benefit themselves to the detriment of the Fund and its shareholders

# Why is §17 So Important to the Fiduciary?

- Because it contains prohibitions and limitations on transactions with affiliated Mutual Funds
  - In general, it is unlawful for an affiliated party, or principal underwriter, to knowingly purchase, sell, borrow, or loan any security, or other property, from or to such Mutual Fund
  - In general, compensation for acting as agent, in connection with the sale of a security to or by an affiliated Mutual Fund, is subject to specified limitations and restrictions
  - Discretionary trust accounts are often invested in Mutual Funds, and these fiduciary investments (in the aggregate) may limit investment opportunities for the bank

# What is an “Affiliated Mutual Fund”?

- › An “Affiliated Mutual Fund” is:
  - Any Fund for which an affiliated entity of the bank serves as the principal underwriter
  - Any Fund for which an affiliated entity of the bank serves as the fund adviser
  - Any Fund of which the bank holds, with the power to vote, 5% or more of the Fund’s outstanding securities
  
- › Labeled as first tier, second tier, or third tier
  - › The prohibitions and limitations on transactions with affiliated Mutual Funds apply only to first and second tier affiliates

# First, Second, or Third Tier?

- The term “tier” designates an affiliate’s rank within the layers of the relationship, starting with the affiliated Mutual Fund





# Caution! Tiers May Be Collapsed

- There is the potential that the tier level, between 1<sup>st</sup> and 2<sup>nd</sup> tier affiliates, may be collapsed
  - SEC has published differing opinions on this issue. Compare current approach to 1995 Salomon letter. See also, *“Classifying Affiliates Under the Investment Company Act,”* David M. Geffen, Aspen Publishers, Vol. 16, No. 2, February 2009.

# If Your Head Isn't Spinning Yet...

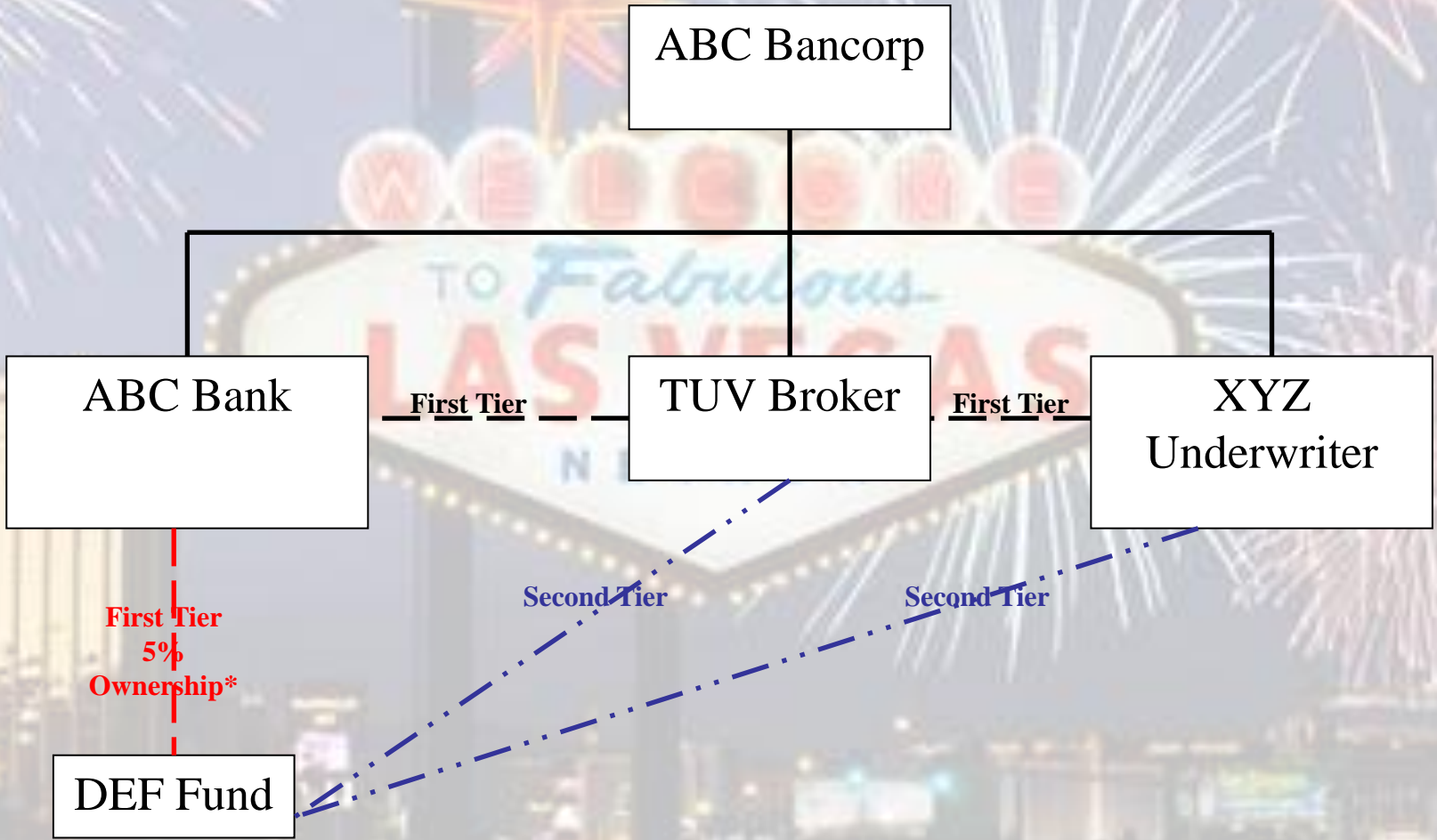
- The next slide will make it feel like its spinning



# Example #1

- › Example - *ABC Bancorp* has three wholly owned subsidiaries, *ABC Bank*, *TUV Broker*, and *XYZ Underwriter*. *DEF Fund* is a separate registered investment company. *ABC Bank holds*, with the power to vote, 5% or more (but not greater than 25%) of *DEF Fund's* outstanding shares:
  - *ABC Bank*, *TUV Broker*, and *XYZ Underwriter* are first tier affiliates of each other due to common control (*ABC Bancorp*)
  - As holder of 5% or more of *DEF Fund's* outstanding shares, *ABC Bank* is a first tier affiliate of *DEF Fund*
  - As affiliates of a first tier affiliate, *TUV Broker* and *XYZ Underwriter* are second tier affiliates of *DEF Fund*

# Example Illustration – ABC holds > 5% of DEF\*

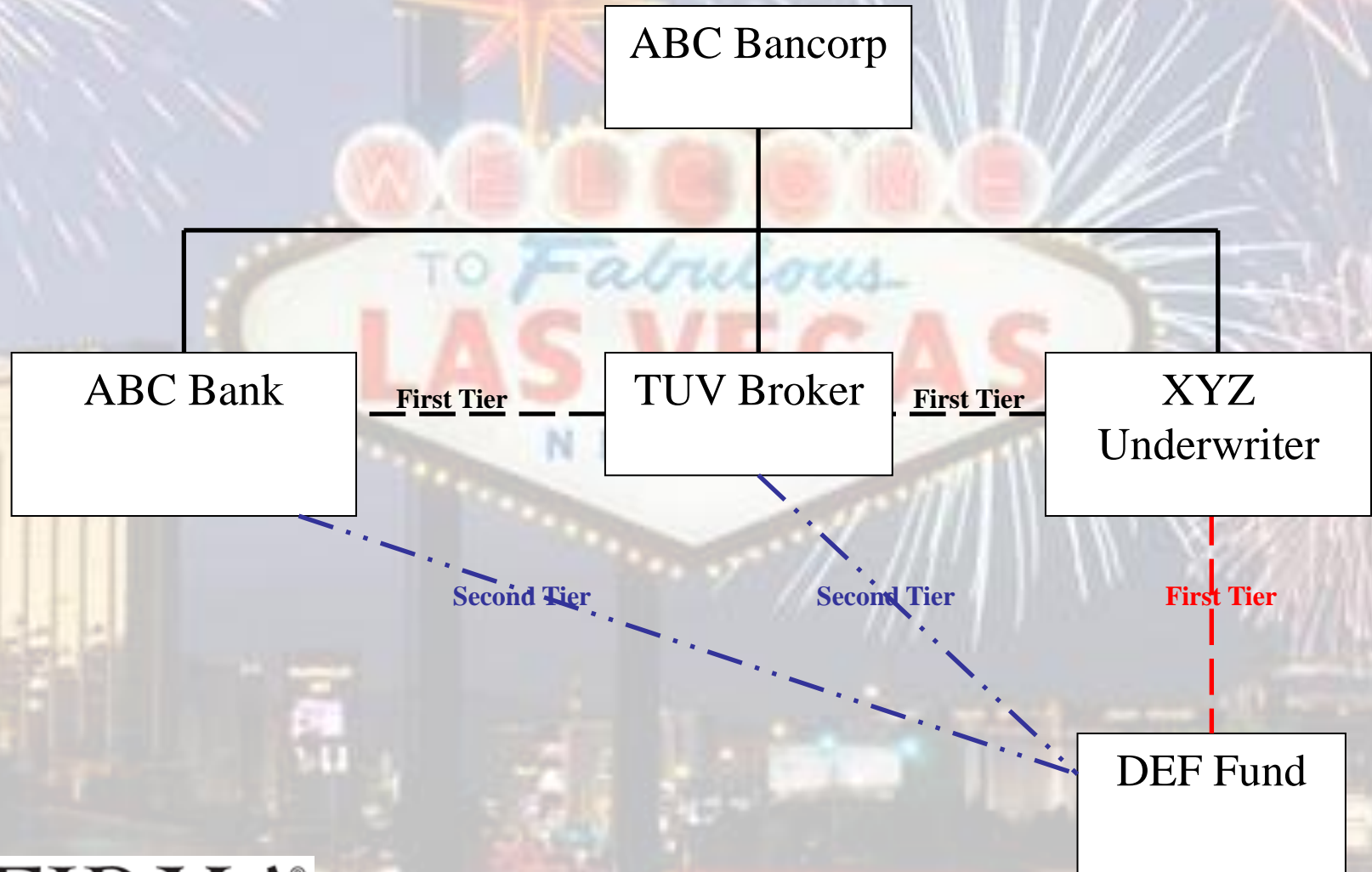


\*Assumes that ABC Bank does not hold more than 25% of DEF Fund's voting securities.

# Example #2

- Example - *ABC Bancorp* has three wholly owned subsidiaries, *ABC Bank*, *TUV Broker*, and *XYZ Underwriter*. *XYZ Underwriter* serves as distributor (principal underwriter) for *DEF Fund*, a separate registered investment company:
  - *ABC Bank*, *TUV Broker*, and *XYZ Underwriter* are first tier affiliates of each other due to common control (*ABC Bancorp*)
  - As principal underwriter, *XYZ Underwriter* is a first tier affiliate of *DEF Fund*
  - As an affiliate of a first tier affiliate, *ABC Bank* and *TUV Broker* are second tier affiliates of *DEF Fund*

# Example Illustration – XYZ underwrites DEF



# What is “Control”?

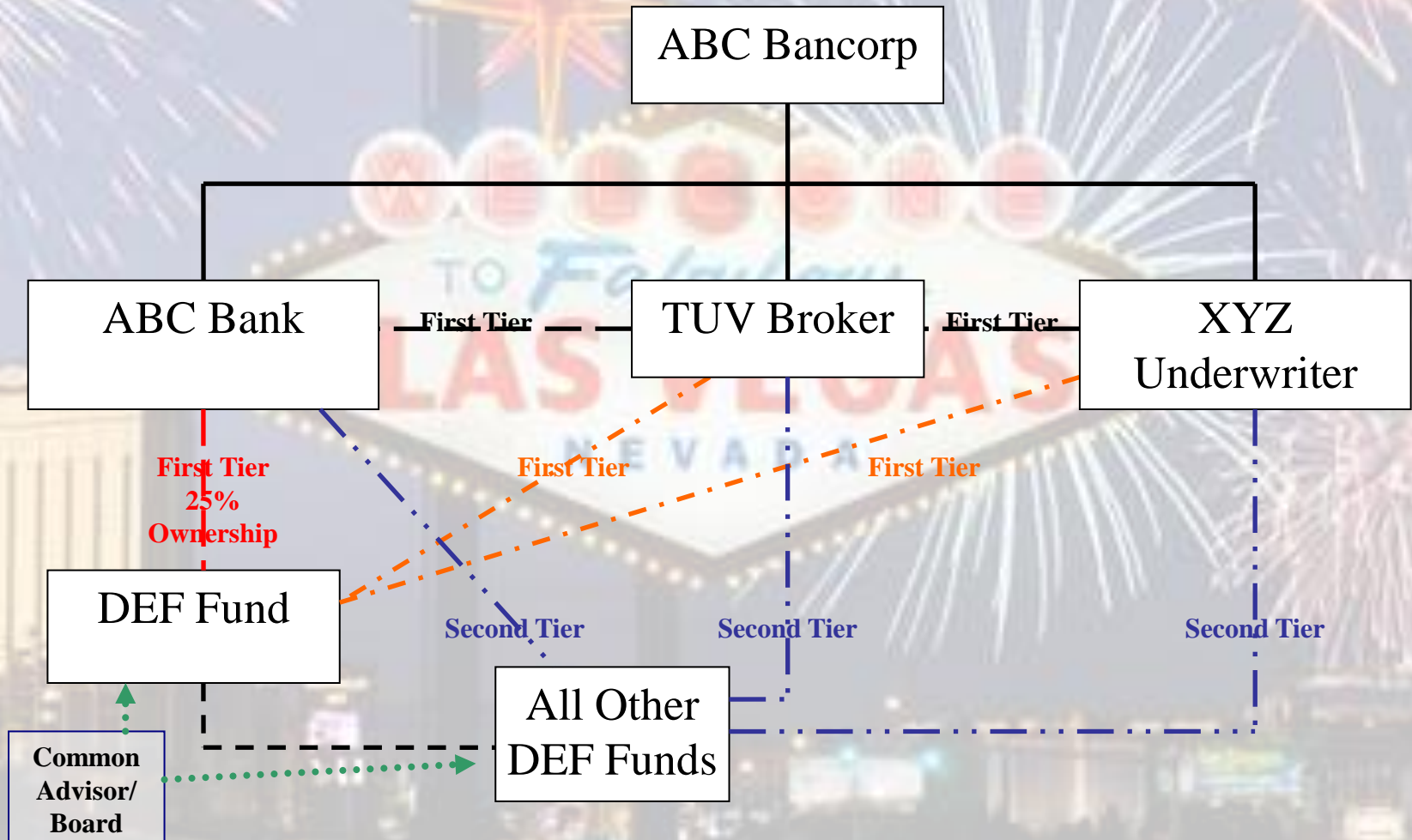
- › “Control” refers to the ability to influence the management or policies of an affiliated Mutual Fund
- › “Control” is presumed when the bank holds, with the power to vote, more than 25% of the Fund’s outstanding securities
- › When “control” is presumed, the affiliate entities (the tiers) will be collapsed, making all Bancorp entities first tier affiliates of the Mutual Fund, and second tier affiliates of “Other Funds” within the same fund family

# Example #3

- Example - *ABC Bancorp* has three wholly owned subsidiaries, *ABC Bank*, *TUV Broker*, and *XYZ Underwriter*. *DEF Fund* is a separate registered investment company within the *DEF Fund Family*. *ABC Bank* holds, with the power to vote, more than 25% of *DEF Fund's* outstanding shares:
  - *ABC Bank*, *TUV Broker*, and *XYZ Underwriter* are first tier affiliates of one another due to common control (*ABC Bancorp*)
  - As holder of more than 25% of *DEF Fund's* outstanding shares, *ABC Bank* is a first tier affiliate of *DEF Fund*
  - Because control is presumed, the affiliate entities are collapsed, making *TUV Broker* and *XYZ Underwriter* first tier affiliates of *DEF Fund*
  - As first tier affiliates of *DEF Fund*, *ABC Bank*, *TUV Broker*, and *XYZ Underwriter* are second tier affiliates of all “Other Funds” within the *DEF Fund Family*



# Example Illustration - Control



# What Is A “Transaction”?

- › It’s not always what you think
  - Purchase / Sales of securities or other property
    - In-kind distribution of portfolio securities to meet a redemption request held to involve a “purchase” or “sale”
    - Foreign exchange transactions held to be “purchase” or “sale”
  - Borrowing from, or lending to, an affiliated Mutual Fund
    - Includes money or other property (e.g. securities lending)
    - Payment of advisory fees in advance held to be “borrowing”
    - Failing to reimburse an affiliated Mutual Fund for excess expenses while at the same time accepting a management fee held to be “borrowing”

# “Transaction” ...

- › § 17(a) imposes prohibitions on principal transactions
  - › The bank may not knowingly sell any security, or other property, to an affiliated Mutual Fund, unless exemptive relief exists
  - › The bank cannot buy or sell for its own account
  - › The bank cannot sell its own proprietary security or instrument (e.g. Bancorp commercial paper) to an affiliated Mutual Fund
  - › The bank cannot borrow money or other property from an affiliated Mutual Fund
  - › The bank cannot lend money or other property to an affiliated Mutual Fund, unless the loan is unsecured

# “Transaction” ...

- › § 17(e) imposes compensation limitations on agency transactions
  - › Either the bank or its affiliated broker-dealer may accept compensation for engaging, as agent, in purchase/sales transactions with an affiliated Mutual Fund in the course of its business as an *underwriter*
  - › Only the bank’s affiliated broker-dealer may accept compensation for engaging, as agent, in purchase/sales transactions with an affiliated Mutual Fund in the course of its business as a *broker*
    - › *Some limitations on compensation may apply*

# How Do We Ensure Compliance at the Entity Level?

- › Need to have a program for the Entity
- › Need to have procedures
- › Need to have training
- › Need on-going assessments to ensure compliance
- › Need a mechanism to escalate and report potential and actual violations
- › Need to perform root cause analysis and adjust the program if needed

# Which Business Lines Should Be Included In the Program?

- › Determining Factors:
  - Does the Business Line create affiliations?
  - Does the Business Line engage in business, enter into transactions, or facilitate transactions with Mutual Funds?
  - Does the Business Line engage in securities transactions on behalf of a Mutual Fund?
  
- › **If YES to any of the above, then the Business Line should be included in the Program**

# Examples of Participating Business Lines (PBLs)

- Investment Advisor
- Security Services
- Wholesale Banking
- Treasury

# Four Recent Examples of Affiliation Issues

1. Directed purchases by client
  - Client directs a purchase of a large block of shares in a particular mutual fund. As a result, the account now controls 5% or more of the mutual fund's voting shares, making it an affiliated mutual fund
2. Foreign Exchange Department's ignorance of the rule
  - Section 17(a) prohibits affiliated parties from transacting in securities or other property. Affiliated mutual fund needed to exchange currencies to settle a trade. Foreign Exchange did not understand that "other property" included currency
3. External party liquidates a large block of shares
  - Unrelated third party sells a large block of a mutual fund's shares, thereby significantly decreasing the number of outstanding shares. As a result, bank's ownership, through its fiduciary accounts, in that particular mutual fund increases to 5% or more
4. Remarketing of Tender Option Bonds
  - Bank serves as remarketer for issuer of Tender Option Bond (TOB). Affiliated mutual fund purchases TOB and later tenders to remarketer. Bank may be prevented from fulfilling its duties as remarketer because remarketing is considered a principal transaction.
    - If you are in the capital markets business, you will need to look at how revenue is shared (i.e. Designated vs. Group-net)



# Our New Understanding...



The background of the slide is a night-time photograph of the iconic 'Welcome to Las Vegas' sign. The sign is illuminated and features a compass rose at the top, the word 'WELCOME' in circular letters, and 'LAS VEGAS NEVADA' in large red and blue letters. The scene is filled with numerous colorful fireworks exploding in the dark sky. The overall image has a semi-transparent overlay.

**Any Questions?**



*Thank You!*