Simpson Thacher

Registered Funds Alert

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This latest edition of Simpson Thacher's Registered Funds Alert discusses: the potential impact of the election on funds and their sponsors; a new data analytics tool that the SEC has developed to take advantage of industry data; a decision in a Section 36(b) case that could undermine attorney-client privilege for boards and their counsel; and potential lessons from recent SEC actions related to valuation issues.

The Impact of the Trump Administration on Regulation of Registered Funds and Their Sponsors by the SEC

Inauguration Day 2017 would have marked a change in presidential administrations regardless of the outcome of the election, but it is safe to say that few predicted that the election would result in a victory by Donald Trump and Republican control of both houses of Congress. Thus, even though the Securities and Exchange Commission ("SEC") is an independent federal agency with representation from both parties, we would expect there to be significant changes to the regulatory and policy priorities of the SEC. Precisely what those changes will be hard to predict, especially because President Trump has not shown himself to be tied to the Republican Party position on all issues, and the Republican Party has not indicated that it will accede to the President's policy positions in every instance. This Alert nonetheless attempts to address what may lay ahead for registered funds and their sponsors.

Policy Initiatives of the New Administration and Nominee for SEC Chair

The SEC's statutory mission is to: protect investors; maintain fair, orderly and efficient markets; and facilitate capital formation. It goes without saying that President Trump's policy priorities fall largely in the third category—facilitating capital formation. Indeed, in the statement nominating a new SEC Chair, the transition team noted that "[w]e need to undo many regulations which have stifled investment in American businesses, and restore oversight of the financial industry in a way that does not harm American workers."

It does not automatically follow, however, that emphasis on the third category of the SEC's mission means that the former two will be ignored, In the same statement, the transition team also noted that "[r]obust accountability will be a hallmark" of the SEC. Ideologically, the view that markets should be lightly regulated but bad actors should be identified and punished—to maintain faith in markets—is one widely held by right of center economists and policymakers.

To accomplish these twin goals, President Trump has nominated Jay Clayton, a partner at a large NY-based corporate law firm, to succeed Mary Jo White as chair of the SEC. Mr. Clayton's legal practice has focused on securities law, including mergers and acquisitions, capital markets offerings and regulatory and enforcement matters. His nomination has received a mixed reaction from Capitol Hill, as he has no government experience or prosecutorial background (although both factors were likely seen as assets, not liabilities, from the perspective of the President). While some media reports have focused on the fact that Mr. Clayton is likely to have significant conflicts and will need to recuse himself from matters involving any of his former Wall Street clients or his wife's employer (a large investment bank), his conflicts do not appear to be any greater than those faced by Chair White, who previously represented Wall Street clients herself and who also had to recuse herself from matters involving clients of her husband's law firm. There has been little debate, however, regarding the quality of Mr. Clayton's intellectual, legal and securities bona fides.

Other than the statements from the transition team that suggest some indication of his priorities, little is known about Mr. Clayton's personal policy views. Mr. Clayton has not made any significant statements regarding policy initiatives, although he did co-author an opinion piece in 2015 acknowledging the seriousness of cybersecurity threats and advocating for greater collaboration between government and the private sector, both domestically and internationally. His familiarity with cyber-security challenges will likely be helpful in this ever-evolving area. It is also likely to provide comfort to the dozens of industry representatives, including Simpson Thacher, who raised concerns about the expansion of information to be submitted to the SEC without standards for the appropriate safeguarding of that information by the SEC. But outside of that familiarity, there is not much that can be gleaned from his public record. We also note that his professional history has not involved significant representation of registered funds or their sponsors.

As of the date of this Alert, Mr. Clayton's confirmation hearing has not been scheduled, although there have been reports that it could take place in early February. While it is possible that it could take several months for Mr. Clayton to be confirmed as SEC chair (Chair White's confirmation took nearly four months), there do not appear to be any impediments to a swift confirmation.

Neither a new presidential administration nor a new SEC Chair necessarily augurs a change of key personnel at the SEC Division of Investment Management, since none of the positions, including Division Director, are political appointees. Given that Mr. Clayton, once confirmed, will need to find replacements for departing heads of the Divisions of Corporate Finance, Enforcement and Economic

and Risk Analysis, and the office of Compliance Inspections and Examinations, we would not expect any imminent changes in key personnel at Investment Management. Division Director David Grim, who has been at the SEC through several SEC chairs, expressed his belief at the ICI's December 2016 Securities Law Developments Conference that more things will stay the same than change under a new chair. The SEC is a large agency, with nearly 4,000 employees, and changing its direction is more like steering a freighter than a speed boat. Mr. Grim noted that the SEC Staff often spends a significant amount of time getting new appointees up to speed after an administration change, which may delay certain rulemaking and other initiatives.

Congressional Legislation

When the Financial CHOICE Act of 2016 ("CHOICE Act") was initially proposed by Congressman Jeb Hensarling in September 2016, many viewed the legislation as unlikely to be adopted. However, the results of the election—with Republicans set to control both houses of Congress and the White House—drastically improved the prospects for the CHOICE Act, or similar financial reform legislation. In fact, proposals similar to those found in the CHOICE Act have already appeared in separate bills, such as a recent bill that passed the House of Representatives that would require additional cost-benefit analysis for SEC rule proposals related to anticipated costs a rule would impose on the financial industry.

The CHOICE Act is a sweeping piece of financial reform legislation that would, among a myriad of other reforms, repeal portions of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), remove the power of the Financial Stability Oversight Council (FSOC)

"While the CHOICE Act is a long way from becoming law, if enacted, it would have significant effects on the SEC and its rulemaking process …"

to designate non-bank financial institutions as systemically important, repeal the Volcker Rule and reform the Consumer Financial Protection Bureau. While the CHOICE Act is a long way from becoming law, if enacted, it would have significant effects on the SEC and its rulemaking process, as discussed further below. In addition, certain provisions would provide highly desired relief to certain funds and sponsors. For example, the CHOICE Act, as proposed, includes several amendments to the Investment Company Act of 1940 Act ("1940 Act") that would allow business development companies ("BDCs") greater ability to invest in certain types of unregistered vehicles and lower the asset coverage requirements for BDCs if certain conditions are met and to the Investment Advisers Act of 1940 ("Advisers Act") that would provide an exemption from registration for certain private equity fund advisers. It is possible that additional amendments could be added during the legislative process.

SEC Rulemaking

As we have discussed in prior Alerts, in December 2014, Chair White announced a multi-part asset management rulemaking initiative. To date, the SEC has adopted new data reporting requirements for registered funds and advisers and liquidity risk management rules for registered funds. Additionally, the SEC has proposed rules for registered funds related to electronic delivery of shareholder reports and use of derivatives, plus a rule that would require registered advisers to develop and maintain written business continuity and transition plans. Based on when each rule was proposed, the rules relating to electronic delivery of shareholder reports and derivatives use would appear to be closer to adoption than the rule that would require business continuity and transition plans for registered advisers, and Mr. Grim confirmed this perception in remarks during December's ICI conference. Additional rules that reportedly are being formulated by the SEC, but have not yet been proposed, include stress testing requirements, a rule that would require investment advisers to undergo an annual examination by a third party as a way to supplement SEC examinations, and a rule to promote diversity in the board room that could apply to fund boards.

While there have been no definitive statements from the incoming administration regarding the ultimate fate of pending SEC rulemaking initiatives, the White House issued a memorandum shortly after the President was inaugurated that directed all regulatory agencies to freeze all pending rulemakings until the incoming administration has an opportunity to fully review all pending rules and to delay for at least 60 days the implementation of rules that have been finalized but not yet implemented. SEC Commissioner Michael Piwowar, the sole Republican commissioner who was named interim chair as Mary Jo White left her post after the inauguration, has stated that due to the SEC's limited resources he does not intend to "move forward with something that is going to be repealed or changed anyway." While he has not specifically cited any asset management rulemakings as fitting that description, he has indicated that Dodd-Frank rulemakings

fall into that category, which includes the stress-testing rule and arguably the transition-planning and derivatives rules. We also would not expect a board diversity rule to be a priority of the incoming administration. Commissioner Piwowar's position that certain rules should not be adopted will carry even more weight given Chair White's departure, as he and Kara Stein are the only two Commissioners remaining and any new rule will require that they both agree to its adoption.

With respect to the electronic delivery rule, which is widely seen as pro-industry but has been subject to significant resistance from the paper industry, Commissioner Piwowar has been a strong advocate. Given strong support from Republicans, one would normally expect a version of the rule to be adopted either under Commissioner Piwowar's interim chairmanship or shortly after there is a full complement of Commissioners. However, the paper industry employs many American workers in communities that voted for Donald Trump. That rule may be an area where President Trump's views depart from Republican orthodoxy.

With respect to the derivatives rule, while there are many who would prefer all rule-making be shelved, there are significant industry voices who would prefer some level of certainty with respect to derivatives rules, as opposed to being subject to the vagaries of the disclosure review process to work through technical issues. Commissioner Piwowar supported the proposal of a derivatives rule that focused on asset segregation and did not have a limitation on notional derivatives exposure (as contained in the proposed rule issued last year). It would not be surprising to see a re-proposal, or potentially even an adoption, of a derivatives rule that limited undue risk solely through an asset segregation approach. These two examples exemplify the complexity of predicting rule-making developments—in some cases Republicans and President Trump will have different priorities, in some cases different industry participants will have different priorities. It is extremely unlikely that rule-making will cease simply because the prevailing sentiment is to lessen the regulatory burden on industry participants.

There may also be influences from Capitol Hill that have direct bearing on the SEC. The CHOICE Act includes several provisions that could slow down the SEC rulemaking process (and may impact other financial regulators as well). One of these provisions would establish a minimum comment period of 90 days for public comment on any proposed rulemakings. Currently, the SEC typically allows between 30 and 60 days for public comment. The SEC would also be required to submit any agreements on international or multi-national securities standards to a public notice and comment process. Additionally, all new "major" SEC rules (for example, those with a $100 million annual anticipated impact on the U.S. economy) would need to be presented to Congress, and both houses of Congress would need to issue a joint resolution approving the rule before final implementation. If Congress does not issue the required joint resolution, a rule simply would not go into effect. Congress would also have a mechanism to disapprove of non-major rules. Furthermore, the CHOICE Act would provide a specific private right of action for anyone adversely impacted by a final rule to bring a court challenge within one year from the publication of the final rule in the Federal Register. The CHOICE Act also requires the SEC to do a five-year retrospective analysis of the impact of new rules (and a review of current rules).

SEC Interpretive Guidance and Exemptive Relief

There are several reasons to believe that the SEC may increase its issuance of interpretive guidance and exemptive relief as a result of the current political climate. If the new administration takes the approach of reducing regulatory burdens, one way of accomplishing that goal is to utilize the SEC's interpretive and exemptive authority. We anticipate that funds and their advisers will approach the SEC Staff for novel relief with less hesitation, as the new administration could present an opportunity to seek clarity with respect to certain gray areas of the 1940 Act and Advisers Act (and their respective rules). Additionally, if the CHOICE Act or similar legislation is passed and contains a requirement for a joint resolution of Congress approving any new rule, as noted above, it is possible (or even probable) that the SEC and its Staff would turn to their interpretive and exemptive authority to enact regulatory reform and bypass political logjams that could gum up the rulemaking process.

SEC Examinations and Enforcement

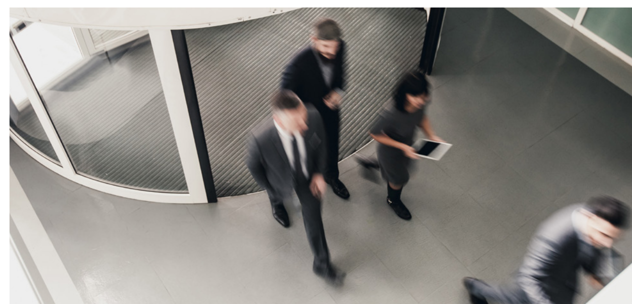
The SEC's Office of Compliance Inspections and Examinations ("OCIE") officially announced its 2017 examination priorities on January 12, 2017. Notably, the examination priorities release explicitly states, for the first time, that OCIE's objectives are to be "data-driven and risk-based" and it has incorporated data analytics into examination initiatives "to identify industry practices and/or registrants that appear to have elevated risk profiles." Additional discussion of the SEC's increasing use of data analytics can be found later in this Alert, but it is clear that data analysis is now driving examinations.

The examination priorities do not include many specific initiatives targeting registered funds and their advisers, other than cybersecurity policies and controls. The lack of discussion around funds and advisers belies what the SEC has emphasized in other contexts. For instance, in its 2017 Budget Justification to Congress (which is now unlikely to be approved), the SEC requested funding to hire 127 additional examiners for OCIE, of which 102 would have focused primarily on conducting additional examinations of investment advisers and investment companies. Some insight regarding OCIE's asset management priorities was provided by representatives from OCIE and the Division of Enforcement ("Enforcement") at the December ICI Conference. The asset management priorities that they cited included valuation, affiliated transactions (including cross-trades and principal transactions) and the advisory contract renewal process for registered funds under Section 15(c) of the 1940 Act.

The President has not made any detailed statements regarding enforcement goals for the SEC under his administration, other than generally noting accountability for Wall Street as a focus. Some SEC observers have commented that the transition in administrations could result in lower financial penalties associated with SEC enforcement actions, citing a statement published by the SEC in 2006 when Paul Atkins was a commissioner. Mr. Atkins is a key member of the President's transition team, and likely was very involved in the selection of Mr. Clayton as the nominee for SEC chair. The 2006 SEC statement raised concerns that financial penalties against companies posed a risk of shifting the burden of wrongdoing to its shareholders, and stated that the "likelihood a corporate penalty will unfairly injure investors, the corporation, or third parties weighs against its use as a sanction." Additional support for a possible reduction in corporate-level enforcement penalties can be found in the fact that the CHOICE Act includes a requirement for SEC economists to analyze the potential impact of a financial penalty on a company's shareholders in connection with an enforcement action.

While this potential shift in the SEC's approach to enforcement penalties would be welcomed by operating companies, it does not appear that funds and advisers would benefit to the same degree. When the SEC brings an enforcement action for a violation involving an operating company, the penalties are usually borne by the company directly, and its shareholders indirectly. In the fund context, however, the SEC typically brings an enforcement action against the fund's sponsor or adviser, sparing the fund and its investors. Thus, even if the SEC begins to reduce enforcement penalties against operating companies, it is unclear whether advisers can expect similar treatment (except to the extent the advisers themselves are public companies).

Many industry observers have speculated that a Republican-controlled government and SEC may lead to fewer enforcement actions. For evidence, they point to a provision of the CHOICE Act that proposes to raise the SEC's burden of proof in administrative proceedings from a "preponderance of the evidence" standard to a "clear and convincing evidence" standard. This change would mean that the SEC must prove that it is substantially more likely than not that an allegation is true, as opposed to it being only more likely than not. In practice, it remains to be seen whether there is a material distinction between these standards that will impact the SEC's enforcement decisions, but legislation that proposes to raise the SEC's burden of proof certainly indicates a desire to reduce enforcement actions, or a desire to encourage more litigation of such actions.



As discussed in more detail later in this Alert, with the finalization of new data reporting requirements for registered funds and advisers, OCIE and Enforcement appear poised to have access to significantly more information that can be analyzed to unearth "red flags" for further inquiry. SEC Staff members have stated that registrants can expect to be contacted when such a red flag arises, but have tried to emphasize that such red flags may be related to filing errors or other mistakes and will not trigger immediate opening of investigations without a registrant having the opportunity to explain or correct any issues.

The SEC's efforts at data analysis may be hindered, however, as the CHOICE Act proposes to abolish the SEC's reserve fund housed within the U.S. Treasury. The Dodd-Frank Act established the reserve fund, which allows the SEC to deposit up to $50 million in registration fees per year and hold a balance of up to $100 million. The SEC has discretion in how it uses the reserve fund, but requires reporting to Congress regarding any disbursements. The SEC has used the reserve fund primarily to upgrade and modernize its technology systems, including its

data analytics capabilities. Abolishing the reserve fund could hinder the SEC's ability to analyze data, and could increase the risk of cybersecurity attacks targeting the confidential information that the SEC collects from registrants. The elimination of the reserve fund is somewhat at odds with the CHOICE Act's proposed requirements for the SEC to develop comprehensive risk control mechanisms to safeguard confidential data held by the agency, as it eliminates a potential source of funding for the SEC to enhance its cybersecurity preparedness.

* * *

It is difficult to predict with certainty how the regulatory landscape will change for registered funds and their sponsors during the tenure of the new administration. With weeks or months to go, in all likelihood, before a new chair is confirmed, and with two commissioners of opposing political parties currently in place, one should not expect any significant developments for some time.

Surprising Decision Compels Mutual Fund Directors to Produce Attorney-Client Communications in Discovery, Despite Claims of Privilege

A recent ruling requiring that a mutual fund's independent trustees produce e-mails with board counsel despite an attempt to invoke attorney-client privilege is making waves in the mutual fund industry.

Attorney-client privilege is a long-standing and well-established doctrine that protects certain communications between clients and their attorneys from disclosure. Its necessity and purpose—to encourage full and frank communication between attorneys and their clients—is rarely questioned, and few people thought it would become an issue in the context of excessive fee litigation under Section 36(b) of the 1940 Act. It came as a surprise to almost all observers when the federal judge presiding over *Kenny v. Pacific Investment Management Company LLC* [1] issued an order doing just that in November.

The plaintiffs in *Kenny* are suing the adviser over the fees the adviser charged its flagship fund, and sought access to hundreds of e-mails and other documents involving the fund's independent trustees in relation to that suit. The independent trustees complied with many of the discovery requests on their own, delivering over 2,300 pages of documents, including some communications between independent trustees and board counsel, but also held back or redacted an additional 200 documents, arguing that those documents were protected from disclosure by attorney-client privilege because they contained confidential legal advice regarding board meetings, director retirements, board governance and contract approvals.

Generally speaking, parties to federal litigation may obtain discovery of any relevant information, and relevant information is construed to mean anything that is reasonably calculated to lead to the discovery of admissible evidence. It is a wide umbrella to be sure, but privilege usually constrains its reach. If requested discovery is resisted, the requesting party may move for an order compelling such discovery.

In *Kenny*, the plaintiffs moved for such an order to compel the discovery materials the independent trustees withheld as attorney-client privileged material. But rather than contest whether the withheld documents were in fact privileged, as usually happens in these contexts, the plaintiffs focused the court's attention on a centuries-old, but rarely invoked, aspect of the attorney-client privilege doctrine in the context of fiduciary litigation.

In those jurisdictions where it is recognized, the so-called "fiduciary exception" precludes a fiduciary from asserting the attorney-client privilege against beneficiaries who seek disclosure of fiduciary-attorney communications. Essentially, application of the fiduciary exception compels disclosure to beneficiaries where the fiduciary sought legal advice in exercising the fiduciary's duties and responsibilities to those beneficiaries on the theory that the fiduciary's duty to administer the trust solely for the benefit of the beneficiaries takes priority over the attorney-client privilege.

The fiduciary exception to the attorney-client privilege was imported to the United States through English common law, where courts concluded that communications between a fiduciary and his or her attorney must be disclosed to a trust beneficiary, essentially holding that because communications between an attorney and a fiduciary ultimately benefit the beneficiary, such communications cannot be withheld from the beneficiary.

The Supreme Court of the United States reviewed the fiduciary exception to attorney-client privilege in 2011 in the context of the general trust relationship between the United States and Native American

1. *Kenny v. Pacific Investment Management Company LLC et al*, No. 2:2014cv01987 - Document 140 (W.D. Wash. 2016).

tribes, renewing interest in the previously obscure doctrine.[2] It did so based on an evaluation of two criteria: (1) whether the trustee obtained legal advice as a "mere representative" of the beneficiary, making the beneficiary the "real client;" and (2) whether the fiduciary duty to furnish trust-related information to the beneficiaries, rooted in the trustee's fiduciary duty to disclose all information related to trust management, outweighs the interest in the attorney-client privilege. Under that line of cases, only where the trustee shows that he or she obtained legal advice for his or her own personal protection or independent personal purpose will the attorney-client privilege survive.

The plaintiff in *Kenny* argued that because the fund is organized as a series of a Massachusetts business trust, the fiduciary nature of the independent trustees under federal law would make the Supreme Court precedent applicable. Specifically, the plaintiffs argued that the communications at issue involved the independent trustees in their role as fiduciaries and related to administration of the fund, and therefore were explicitly not for the trustees' personal benefit. To bolster this argument, the plaintiffs highlighted the Fund's administration agreement which states that the trust pays "the fees and expenses of legal counsel retained for [the Trust's] benefit."

Counsel for the independent trustees disagreed. Citing 45 years of Section 36(b) lawsuits, they argued that the fiduciary exception has never been extended to the mutual fund context. They went on to argue that the independence of the trustees would be undermined if their ability to freely communicate with independent legal counsel under the attorney-client privilege were chilled, so much so that it would "destabilize the mutual fund industry to the detriment of all shareholders."

Ultimately, the court concluded that the independent trustees failed to meet their burden of showing why the discovery request should be denied and the plaintiff's motion to compel discovery was granted. The order rested on the assertion that the independent trustees are supposed to be independent from the fund's adviser, not the shareholders; and that the fund in question is undisputedly organized as a trust. The presiding judge determined that those facts were analogous enough to Supreme Court precedent to warrant application to the mutual fund context. As of this date, the adviser and the independent trustees have not appealed the order. Although the *Kenny* decision is less than a few months old, it has already been cited by plaintiffs in other ongoing 36(b) cases as hopeful precedent, although judges in other districts are not bound by the *Kenny* decision.

To the extent that plaintiffs raise the fiduciary exception in attempting to compel discovery of privileged trustee-counsel communications in other Section 36(b) cases, there are several potential ways in which board counsel in other jurisdictions might try to distinguish the *Kenny* order. Although the majority of mutual funds are organized as series of a trust, according to the Investment Company Institute's 2016 Investment Company Fact Book, more than 15% are organized as corporations. Had this particular fund been organized as a corporation, it would have undercut one of the central pillars of the plaintiff's argument. That the court found that independent trustees lose attorney-client privilege simply because a fund happens to be organized as a series of a trust seems remarkably arbitrary. A necessary corollary of the court's conclusion here is that any and all written communication between independent trustees and outside counsel will be available for inspection in Section 36(b) litigation, unless the communication is clearly a matter of advice regarding personal protection for the trustee. As a litany of cases have already concluded, it is essentially a maxim that legal advice can only be safely and readily rendered and relied on when free from the consequences or the apprehension of disclosure. Requiring blanket disclosure as a rule could quickly serve to ensure tough questions do not get asked or answered, or at least not on the written record.

Moreover, it is not clear how exactly the court concluded that the board's outside counsel was actually serving the fund's beneficiaries as its "real client," as opposed to the independent trustees they were responding to and communicating with. Undoubtedly, many communications between independent trustees and their outside counsel focus on navigating the multiple legal and regulatory obligations that the independent trustees are obligated to satisfy; duties that can create liability for those independent trustees if improperly performed and are materially separate and distinct from the concerns and obligations of a mere beneficiary of the fund. Further, it would place the board's counsel in the precarious position of allegedly representing the interests of all of the beneficiaries of the fund without having any way to identify, disclaim or mitigate a situation where that counsel has interests that conflict with those of a beneficiary.

It is uncertain whether other courts will decide to follow the reasoning of this ruling, but the issue will undoubtedly be put before other tribunals soon. Boards and their counsel would be wise to

2. *United States v. Jicarilla Apache Nation*, 564 U.S. 162 (2011).

> *Boards and their counsel would be wise to consider whether certain topics should be discussed over the phone instead of via e-mail.*

consider whether certain topics should be discussed over the phone instead of via e-mail. Importantly, although the court ruled the documents were subject to discovery, the order states that the documents that were ordered to be produced are subject to a protective order to prevent the public disclosure of their contents.

Introducing the Investment Company Risk Assessment Tool: SEC Use of Big Data

As summarized in a prior Alert, new reporting requirements will provide the SEC with more detailed and aggregate information about investment advisers, funds and their portfolios. This data will also be required to be filed in a XML, a structured data format that allows for sophisticated data analysis. The SEC has openly acknowledged that information from the new reporting requirements will be used to support not just rulemaking, but also examination and enforcement efforts. While the new reporting requirements will not take effect until 2018, the SEC is already developing the tools to analyze the massive amounts of new data it will receive. One of these tools, which has not been widely publicized but is worthy of note, is the Investment Company Risk Assessment (the "Risk Assessment Tool").

The Risk Assessment Tool was developed by the Office of Risk Assessment ("ORS") within the Division of Economic and Risk Analysis ("DERA") and is a tool designed to help the SEC put "big data" to use. To put the term "big data" in context, Scott W. Bauguess, Interim Director and Chief Economist of DERA, has characterized it as "any data that approaches our computational limitations on analyzing it." One example of big data is trading data, as a single day's worth of aggregate market trading data would take much longer than one day to analyze, although Mr. Bauguess's characterization means that the concept of big data will change over time as computing power evolves.

DERA integrates sophisticated analysis of economic, financial and legal disciplines with data analytics and quantitative methodologies, and ORS aims to centralize DERA's ongoing work in risk assessment activities. While the majority of DERA staff is focused on the preparation of economic analysis and research in connection with the SEC's rulemaking and policy development function, DERA increasingly facilitates the SEC's ongoing disclosure filing review, inspections by OCIE and investigations by Enforcement. The Risk Assessment Tool is designed to be a part of those efforts. As noted in the SEC's Agency Financial Report (Fiscal Year 2016) ("2016 Financial Report"), "[t]he Investment Company Risk Assessment was operationalized in FY 2016, and creates a system of risk rankings based on detecting anomalous investment company characteristics, allowing Enforcement and OCIE to dig deeper and determine if specific, violative conduct might be occurring at a fund … ." The Risk Assessment Tool is also noted among the SEC's accomplishments regarding efforts to identify potential misconduct with advance analytics tools. Limited information is available about the Risk Assessment Tool, including the entire extent to which it is operational or if final metrics or factors have been determined.

In evaluating the potential impact of the Risk Assessment Tool, it is useful to examine two similar programs developed by ORS, the Corporate Issuer Risk Assessment tool ("Corporate Assessment Tool") and the Broker-Dealer Risk Assessment tool ("Broker-Dealer Assessment Tool"). The Corporate Assessment Tool provides a comprehensive overview of the financial reporting environment and assists Enforcement in detecting aberrant patterns in financial statements that may warrant additional inquiry. The Corporate Assessment Tool grew out of an initiative focused on estimates of earnings quality and indications of inappropriate managerial discretion in the use of accruals. As explained by Mr. Bauguess in a speech, the Corporate Assessment includes "modeling measures of earnings quality as part of more than two hundred thirty (230) custom metrics provided to SEC staff. These include measures of earnings smoothing, auditor activity, tax treatments, key financial ratios, and indicators of managerial actions." The Corporate Assessment Tool enables Enforcement to compare an issuer to its peers in order to detect abnormal results and financial reporting anomalies. The Broker-Dealer Assessment Tool was developed in conjunction with OCIE and helps identify outlier behavior that allows OCIE to prioritize inspections for inappropriate risk or fraudulent activity. As discussed in a speech by Mark Flannery, then-current Director and Chief Economist of DERA:

> "The process works as follows. BDs are first classified by their type of dealing activity—for instance whether or not they carry customer securities on their books (i.e., a "carrying

broker”). This allows staff to analyze how a firm’s behavior compares to its peers. We then look for predictors of potentially anomalous or concerning behavior, which include potential risks related to, for example, its operations, financing, workforce, or firm structure … A score card rates how each firm’s activity in each of these areas compares to its peer firms, and results from these score cards are used to help prioritize the sequence of BD inspections as well as areas for examiners to focus on.”

Similar to the Corporate Assessment Tool, the Broker-Dealer Assessment Tool identifies outlier activities or certain changes over time at a broker-dealer relative to its peers.

As noted above, the Risk Assessment Tool creates a system of risk rankings based on detecting anomalous investment company characteristics and is available to both Enforcement and OCIE. A presentation delivered by DERA staff on February 19, 2016 at the SEC Speaks conference, including Messrs. Flannery and Bauguess, provided some of the possible metrics for the Risk Assessment Tool. In producing a “Risk Ranking,” the Risk Assessment Tool will focuses on four sets of characteristics, as shown in the diagram below.

In looking at these characteristics, including the “Analysis of Fund Characteristics” subcategories, DERA may look to academic studies that model potential misconduct (e.g., dividend juicing or return gaps) in a way that can be recreated by DERA and applied to available data.

While the DERA presentation did not elaborate on any additional factors for investment company characteristics or activities, or give additional details on how they could be weighed, it is apparent that the information provided by the new reporting requirements could feed into several of these factors. For instance, under Form N-PORT investment companies will need to provide fund flow data for each of the preceding three months as part of new liquidity risk information, as well as monthly return and security lending data, which all tie directly to factors identified above. In addition, Form N-PORT will require that each portfolio investment have an identifier number/code. As discussed later in this Alert, valuation has become an examination and enforcement priority and keying individual investments with an identification number would allow the SEC to compare valuations of the same security across various funds and look for outliers.

Although the DERA presentation cited above did not elaborate on “cluster analysis/uniqueness,” DERA has provided some insight on this topic in its white paper titled “Mutual Funds Apart from the Crowd.” In the white paper, DERA regarded uniqueness as employing innovative and unique investment strategies. It then measured fund uniqueness based on a cluster analysis of fund returns, and examined how this measure related to other factors. As the white paper describes:

> “[A]ll strategies are based on the same set of available investment vehicles such as stocks, bonds, derivatives, etc. Therefore, strategies overlap to some degree either due to similar security selection or due to similar methods of changing the selection over time, or both. The degree of overlap in strategies differ across funds. Some overlap more, and therefore, exhibit

a more similar stream of returns. Others overlap less and, therefore, have a more unique return streams, which are less substitutable."

In the white paper, DERA defined cluster analysis as a machine learning technique that divides data into groups (clusters) that are meaningful and useful. For example, in the white paper a key cluster/group was fund returns, but one can envision other categories that could be relevant to investment companies, including expenses, duration, sector allocation, etc. By using cluster analysis to measure fund uniqueness, the Risk Assessment Tool could potentially flag fund outliers across many categories. Moreover, as discussed above both Form N-PORT and Form N-CEN will provide the SEC with a tremendous amount of new data that could be used for future cluster analysis.

Although the DERA presentation noted above did not provide any additional factors regarding "text analytics on disclosure," the presentation separately elaborated on DERA's text analytics initiative, which aims to identify "themes" in unstructured narrative disclosure. In examining a document, the Risk Assessment Tool could apply statistical methods to look at the distribution of root words in relation to those in other documents. Also, the Risk Assessment Tool could potentially be used to identify topics in disclosure, and then look for similar themes in other documents. In addition, DERA has begun performing sentiment analysis to assess tonality in filings, which can potentially identify negative tones or tones of obfuscation. As explained by Mr. Bauguess in a speech, once topics and tones are incorporated they can be mapped:

> "into known measures of risk—such as examination results or past enforcement actions—using machine learning algorithms. Once trained, the final model can be applied to new documents as they are filed by registrants, with levels of risk assigned on the basis of historical findings across all filers. This process can be applied to different types of disclosures, or to unique categories of registrants, and the results then used to help inform us on how to prioritize where investigative and examination staff should look."

Tools with text analytics, like the Risk Assessment Tool, could be trained to learn disclosures associated with misconduct and then identify similar disclosure in other documents. Given the focus on narrative disclosure and that compliance with Form N-PORT and Form N-CEN will begin in 2018, the text analytics of the Risk Assessment Tool will likely be focused on existing reporting requirements, i.e. annual and semi-annual reports on Form N-CSR. The SEC could look to prior enforcement actions involving disclosure issues and use them as a reference point, helping the Risk Assessment Tool in developing its text analytics function and flagging similar disclosure by other registrants.

The Risk Assessment Tool could become a very powerful tool available to the SEC, similar to the Corporate Assessment Tool and Broker-Dealer Assessment Tool. Increasing sophistication of the Risk Assessment Tool could potentially, over time, decrease the need for intensive on-site examinations. It could offset, from the perspective of effectiveness of oversight, any future budgetary cuts in personnel at the SEC. Further, it could obviate the need for third-party exams, as many have called for. Those are lofty goals, but the Risk Assessment Tool seems designed to achieve such goals (whether it succeeds is of course an open question). Although there is currently very limited information regarding the Risk Assessment Tool, we intend to follow its development closely and will report any updates in future Alerts.

Recent SEC Actions Indicate Increased Focus on Valuation Issues

Valuation, particularly the fair valuation of unmarketable securities, is a key topic for advisers to consider in managing registered funds. Advisers and fund boards must diligently monitor the valuation of a fund's investments to ensure the integrity of the fund's net asset value ("NAV") and confirm that proper procedures are in place and are being followed. This Alert discusses several recent SEC actions that bear on fund valuation and raise issues for consideration by advisers and fund boards. These actions seem to confirm statements from the SEC Staff that valuation is an examination and enforcement priority.

Recent Enforcement Action Related to Fair Valuation Error and Attempted Remediation

In October 2016, an adviser agreed to settle SEC allegations, without admitting or denying the SEC's findings, that it improperly valued a large illiquid bond holding using the same fair valuation for a period of more than three years. According to the SEC settlement order, the adviser, under the oversight of the funds' boards of directors, primarily based the fair value of the bond on a third-party analytical tool. The SEC alleged that the adviser failed to take into account certain indicia of value,

including the value at which the funds' traded the bonds, the values at which other holders marked the bonds and other market data. The adviser also allegedly failed to back-test, despite engaging in back-testing for other portfolio investments.

The SEC alleged that, eventually, the adviser discovered a flaw in the third-party analytical tool used to value the bond that had led to an overstatement of NAV of certain funds and related performance figures. The adviser also received inflated fees based on the overstated NAVs.

After discovering the error, the adviser made payments to reimburse the affected funds and shareholders, but the SEC found that the reimbursement was miscalculated and inconsistent with the funds' NAV error correction procedures. In particular, the SEC alleged that the adviser did not calculate the damages to the funds and shareholders with the specificity required by the NAV error correction procedures because it lacked necessary information about underlying shareholder activity in the sub-accounts of intermediaries. Instead of precisely measuring underlying shareholder activity, the adviser used the net subscription and redemption amounts of the intermediary. As a result, shareholders that acted through an intermediary were treated differently from direct shareholders.

The SEC also found that, when the adviser did disclose the error to shareholders, the disclosure was inadequate because the adviser did not disclose that the remediation diverged from the NAV error correction procedures or the potential disparity in treatment between shareholders who acted through an intermediary and direct shareholders.

Lessons for Advisers and Boards

Use of fair valuation is a serious undertaking, particularly when a material portion of a fund's assets are represented by fair valued assets. Fair valuation can be accomplished by different means, but should always be determined pursuant to procedures adopted by, and overseen by, a fund's board. When third parties (such as the third party that provided the analytical tool in this matter) are used to help determine fair valuation, the adviser should undertake thorough due diligence of such third parties and their valuation techniques.

Advisers should monitor whether market information becomes available that would better indicate the value of an investment than a currently-used fair valuation methodology. Indeed, the statute provides that fair valuation should only be used when market quotations are not available, indicating a legislative preference for the use of market activity where feasible. Thus, fair valuation methodologies should monitor for market quotes and could include back-testing (testing the accuracy of a fair valuation by comparing an investment's carrying value at the time it was sold to the actual price at which it was sold), as cited in the SEC's order. If fund directors are aware that such market information exists and is not used, they should inquire of advisers why such market information is not better than a currently-employed fair valuation methodology. Where ambiguity exists, to the extent possible, advisers should seek other sources of valuation, which might include how other funds value the same or similar holdings, as cited in the SEC's order. All determinations should be made in accordance with the fund's valuation procedures.

Funds should have a NAV error correction policy and should follow the policy closely when errors arise, avoiding shortcuts such as the allegation in this case that the adviser used net flows to reimburse omnibus account shareholders instead of seeking more detailed information from intermediaries.

Recent Enforcement Action Related to Valuation of Odd Lots

In December 2016, an adviser agreed to settle allegations, without admitting or denying any of the SEC's findings, that it did not properly disclose the effect that investing in "odd lot" investments might have on an exchange-traded fund's performance and failed to accurately value certain fund holdings. The SEC order describes a scenario where the fund in question purchased odd lot positions (small positions, typically under $1 million) in mortgage-backed securities that traded at discounts to round lots (larger, institutional-sized positions) in the same security. The SEC alleged that, despite the fact that these odd lot positions were purchased at a discount, the fund used a third-party valuation vendor's institutional round lot marks in assigning values to the odd lot positions. This resulted in an immediate increase in the value of each odd lot position, and the fund's NAV, which resulted in inflated performance. Notably, the fund disclosed significantly better performance than one of the adviser's mutual funds that employed a similar overall investment strategy.

The SEC alleged that the adviser was aware of the impact its odd lot holdings were having on the fund's performance and found that the adviser negligently produced misleading disclosures that failed to include this as a reason for the fund's positive performance. These disclosures took the form of monthly commentaries that discussed factors that contributed to the fund's performance and shareholder reports that are required to

include such a discussion. The SEC characterized these issues as arising from inadequate disclosure policies and procedures, as the personnel preparing the disclosures may not have been adequately educated about the impact on valuation of the odd lot investment holdings and were not required to consider the effect of the holdings in describing factors that impacted the fund's performance.

Additionally, the SEC cited the definition of value in Section 2(a)(41)(B) of the 1940 Act and found fault with the fund's valuation of odd lot positions at round lot prices in circumstances in which the fund could not reasonably expect to sell its position at the round lot value. While pricing an odd lot at a round lot value is not always wrong, according to the SEC such a valuation must be substantiated with evidence that the position could be sold at a round lot price. The SEC generally found that while procedures were in place to value securities at the price that would be expected to be obtained in the market and for elevating pricing issues, the policies and procedures did not specifically account for odd lot pricing and did not provide guidance regarding when a person should elevate a pricing issue to the appropriate overseeing bodies.

Lessons for Advisers and Boards

As use of less traditional investment strategies increases, it is important for advisers (especially larger advisers) to ensure that various departments have sufficient understanding of how such strategies can impact each other's responsibilities. Those with compliance and disclosure responsibilities should ensure that investment personnel are aware of the importance of fund valuation procedures and their role in ensuring that fund securities are properly valued. Investment personnel should ensure that compliance and disclosure personnel are educated about ways in which a particular investment holding could impact a fund's portfolio, including the fund's day-to-day operations and performance. Additionally, proper valuation procedures should include not only appropriate triggers for unusual pricing variances, which the SEC order acknowledged were in place in this case, but also clear instructions for elevating pricing issues to the appropriate personnel within the adviser and ultimately to a fund's board.

Valuation of Large Private Companies

While no enforcement action has been announced, the Wall Street Journal has reported that the SEC may be focused on the valuation of mutual funds' holdings in large private companies. These private companies have multi-billion dollar valuations, but there is no liquid market for their shares and they release limited information on their businesses (and may selectively release different information to different investors). As a result, the valuations at which different mutual funds carry their investments in the same private company can vary greatly.

The SEC is reportedly concerned about the wide variance in mutual funds' fair valuation techniques for the same security and the variance that mutual funds' valuations have from a private company's valuations in subsequent private offerings. Most funds' valuation policies provide for multiple fair valuation techniques that can be used to value an illiquid security. Even if the same valuation technique is used and funds are relying on the same information from the private company, there are still subjective determinations that must be made. For example, one fair valuation technique would be to multiply the private company's EBITDA by a market multiple, which requires identifying benchmark companies and determining what multiple is appropriate based on the relationship between those benchmark companies' market capitalizations and EBITDA figures. Different parties could arrive at significantly different determinations of what the appropriate multiple is, which can result in wide range of valuations for the same issuer.

In addition, the SEC may take issue with mutual funds using the market multiples of public companies as a proxy for multiples for private companies because public companies, which are typically more mature and are subject to more detailed reporting obligations, are inherently different than private companies. Public companies are more likely to have weathered the ups and downs of growth cycles and market vagaries under the watchful eye of investors. Therefore, the market's valuation of these companies factors in extensive public information about these companies, including the knowledge of past, present or future struggles. On the other hand, earlier-stage private companies—many of which have not yet been burdened with the expectation of profitability—have often not faced as many market tests. Still, public peers offer a useful reference point for determining private company valuations because comparisons to other private companies do not give insight into liquid market valuations.

It is unclear what, if any, action the SEC will take to address variances in private company valuations. While the focus appears to be on investments in large private companies, the SEC may broaden that focus to fair valuation generally. If the SEC thinks a more uniform system of fair valuation is feasible, it is possible that guidance or rulemaking about fair valuation of private companies may be forthcoming.

M&A Transactions

Acquiror	Acquired or Target Company	Type of Transaction and Status
Janus Capital Group Inc., a global asset manager with approximately $195 billion AUM	**Henderson Group plc**, a global investment management firm with approximately £95 billion AUM	All stock merger (Henderson shareholders will own approximately 57% of Janus Henderson, with the remaining 43% owned by Janus shareholders)
Affiliated Managers Group, Inc., a global asset management company with approximately $700 billion AUM	**Winton Group Ltd.**, a London-based global investment manager with approximately $30 billion AUM and Partner Fund Management, L.P, a San Francisco-based hedge fund sponsor with approximately $4.3 billion AUM	Acquisition of Interest (terms not disclosed)
361 Capital, a boutique asset manager with approximately $2 billion AUM	**BRC Investment Management, LLC**, a global equity asset manager with approximately $879 million AUM	Acquisition (terms not disclosed)
Investcorp, an alternative multi-asset class investment manager with approximately $11 billion AUM	Debt management business of **3i Group PLC** with approximately $12 billion AUM	Acquisition (Subject to regulatory approval: expected to close in the first half of 2017)
Eaton Vance Corp., an asset manager with approximately $343.0 billion AUM	**Calvert Investment Management, Inc.**, (indirect subsidiary of Ameritas Holding Company) a manager of mutual funds with approximately $12.3 billion AUM	Acquisition (terms not disclosed)
Rosemont Investment Partners, LLC, a private equity firm with approximately $142 million AUM	**Boston Common Asset Management, LLC**, a Boston-based investment manager with approximately $2.1 billion AUM	Acquisition (minority stakeholder position)
iM Square, a global investment and development platform	**Dolan McEniry Capital Management**, a Chicago based asset management firm with approximately $5.8 billion AUM	Acquisition (minority stakeholder position)
Teton Advisors Inc., a New York-based multi-strategy investment adviser with approximately $1.5 billion AUM	**Keeley Asset Management Corp.**, a Chicago-based privately owned asset management firm with approximately $2.5 billion AUM	Acquisition (terms not disclosed)
Allianz Global Investors, a New York-based privately owned investment manager with approximately $610 billion AUM	**Sound Harbor Partners**, a New York-based investment firm and private credit manager with approximately $1.14 billion AUM	Acquisition (terms not disclosed)

M&A Transactions *(continued)*

Acquiror	Acquired or Target Company	Type of Transaction and Status
Federated Investors, Inc., an investment manager with $364.3 AUM	**Horizon Advisers**, an unincorporated division of Whitney Bank which is a wholly owned subsidiary of Hancock Holding Company	Acquisition and reorganization of the portfolios of three Hancock Horizon funds
Victory Capital, multi-boutique asset manager based in Cleveland, Ohio with approximately $51.4 billion AUM	**Cerebellum Capital**, San Francisco-based machine-learning investment manager with approximately $104 million AUM	Acquisition (parent of Victory Capital, Victory Capital Holdings, Inc. acquired a minority stake in Cerebellum Capital)
Stepstone Group LP, a global private markets firm with approximately $28 billion AUM	**Swiss Capital Alternative Investments AG**, an international alternative asset manager with approximately $6.5 billion AUM	Acquisition (terms not disclosed)
Mercer Advisors Inc., a national registered investment advisor based in Santa Barbara, California with approximately $9.2 billion AUM	**Pegasus Advisors, LLC**, a registered investment advisor firm based in Dallas, TX with approximately $50 million AUM	Merger (terms not disclosed)
Virtus Investment Partners, Inc., a multi-manager asset management company	**RidgeWorth Investments**, a global investment management firm with approximately $40.2 billion AUM	Acquisition (the transaction values RidgeWorth at $472 million and Virtus will also acquire certain investments at their fair value as of closing, for total consideration of approximately $513 million)
Amundi, a Paris-based global asset management firm with approximately $1.26 trillion AUM	**Pioneer Investments**, an international asset manager with approximately €222 billion AUM	Acquisition (Amundi will acquire Pioneer Investments for a cash consideration of €3,545 million, and Amundi and Pioneer's parent UniCredit will form a long term strategic partnership)
Man Group plc, a Boston-based quantitative asset manager with approximately $78.1 billion AUM	**Aalto Invest Holding AG**, a real asset focused investment manager with approximately $1.7 billion AUM	Acquisition (Man Group would acquire Aalto's entire issued share capital)

Closed-End Fund Initial Public Offerings

Invesco High Income 2023 Target Term Fund (NYSE: IHIT)

Amount Raised (Inception Date):	$216 million (November 22, 2016)
Investment Objective/Policies:	The Fund's investment objectives are to provide a high level of current income and to return $9.835 per share (the original NAV per common share before deducting offering costs of $0.02 per share) to holders of common shares on or about December 1, 2023 (the "Termination Date"). The Fund seeks to achieve its investment objectives by primarily investing in securities collateralized by loans secured by real properties. Under normal market conditions, the Fund expects to invest at least 80% of its managed assets in real estate debt securities, including commercial mortgage-backed securities. The Fund will invest no more than 30% of its managed assets in securities rated below investment grade at the time of investment (below investment grade securities, commonly referred to as "junk bonds"). The Fund intends to pay most, but likely not all, of its net income to shareholders in monthly income dividends. The Fund also intends to distribute its net realized capital gains, if any, once per year. However, in seeking to achieve its investment objectives, the Fund currently intends to set aside and retain in its net assets (and therefore its NAV) a portion of its net investment income, and possibly all or a portion of its gains. This will reduce the amounts otherwise available for distribution prior to the liquidation of the Fund, and the Fund may incur taxes on such retained amount. Such retained income or gains, net of any taxes, would constitute a portion of the liquidating distribution returned to investors on or about the Termination Date. The Fund will continue to pay at least the percentage of its net investment income and any gains necessary to maintain its status as a regulated investment company for U.S. federal income tax purposes.
Managers:	Invesco Advisers, Inc.
Book-runners:	Book-runners: Morgan Stanley, BofA Merrill Lynch and Wells Fargo Securities

First Trust Senior Floating Rate 2022 Target Term Fund (NYSE: FIV)

Amount Raised (Inception Date):	$325 million (December 21, 2016)
Investment Objective/Policies:	The Fund's investment objectives are to seek a high level of current income and to return $9.85 per common share of beneficial interest ("Common Share") of the Fund (the original NAV per Common Share before deducting offering costs of $0.02 per Common Share to holders of Common Shares ("Common Shareholders") on or about February 1, 2022 (the "Termination Date"). Under normal market conditions, the Fund will seek to achieve its investment objectives by investing at least 80% of its managed assets in senior, secured floating rate loans of any maturity. The Fund intends to pay most, but likely not all, of its net income to Common Shareholders in monthly income dividends. The Fund also intends to distribute its net realized capital gains, if any, once per year. However, in seeking to achieve its investment objectives, the Fund may set aside and retain in its net assets (and therefore its NAV) a portion of its net investment income and possibly all or a portion of its gains.
Managers:	First Trust Advisors L.P.
Book-runners:	Morgan Stanley, BofA Merrill Lynch, UBS Investment Bank and Wells Fargo Securities

Simpson Thacher's dynamic, long-standing Registered Funds Practice encompasses all aspects of the investment management business. Our practice is multidisciplinary—it brings together such other areas as securities, mergers and acquisitions, banking, tax and ERISA.

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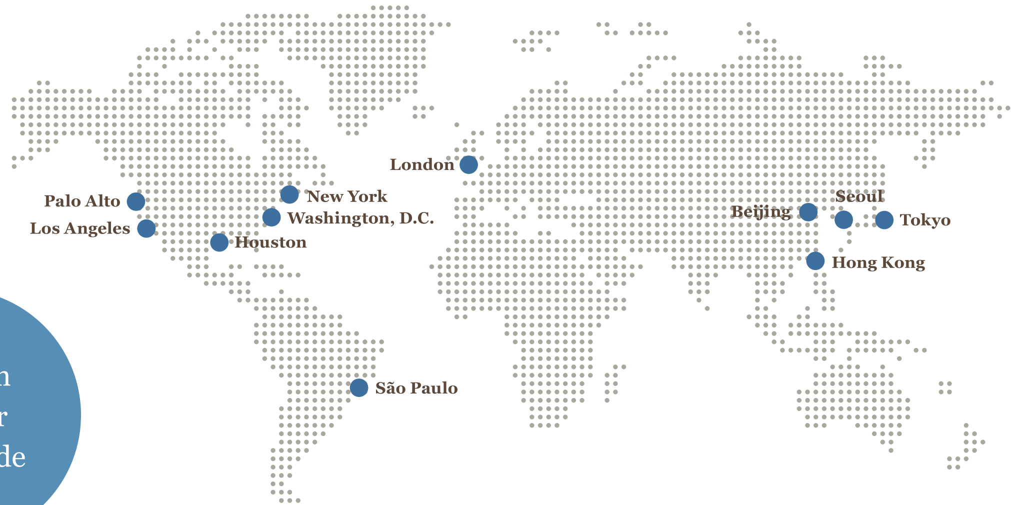

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