Simpson Thacher

Registered Funds Alert

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This latest edition of Simpson Thacher's Registered Funds Alert discusses: the potential role registered funds reform could play in supporting the new SEC Chair's mission to improve capital markets access; re-evaluating the burden on registered fund directors; the growing academic debate over antitrust concerns involving asset managers and mutual funds and potential related policy changes; and the SEC's published Risk Alert on the top five investment adviser compliance issues found during inspections.

Registered Fund Reforms Could Support the New SEC Chair's Mission to Improve Capital Markets Access

President Donald Trump campaigned heavily on promises to reform federal regulations. On May 3, 2017, the Senate confirmed the President's nominee for Chair of the Securities and Exchange Commission ("SEC"), Jay Clayton. Chair Clayton has indicated that he intends to play a key role in helping President Trump fulfill those promises to deregulate. Chair Clayton joins a short-handed SEC, which has been operating with only two Commissioners since January, when former Chair Mary Jo White resigned, and has lost a number of senior staff members since the election, including the heads of multiple divisions and offices within the SEC.[1]

During Chair Clayton's nomination hearing on March 23, 2017, before the Senate Banking Committee, he was questioned by senators about his views on a wide range of matters, including his philosophy regarding enforcement and rulemaking, and his potential conflicts of interest. In this Alert, we will focus on a particular theme that dominated Chair Clayton's testimony—access to capital markets.

In his prepared remarks and in many of his responses, Chair Clayton laid out his vision for clearer and leaner regulation, focusing on the thesis that complexity creates confusion and inflates the cost of compliance for companies. Throughout his testimony, Chair Clayton repeatedly stated his belief that the complexity and upfront costs of initial public offerings (IPOs), as well as continuing compliance costs, are the main factors discouraging companies from going public. Chair Clayton also said that the fixed-cost nature compliance creates a disproportionately heavy burden for smaller and early-stage companies, and that these regulatory-driven costs make public offerings less attractive to those companies. He concluded that well-functioning capital markets benefit all Americans, and that all Americans should have the opportunity to participate in our markets. In other words, when younger companies have IPOs, the general investing public gets to participate in the growth of the company to a greater extent than when companies go public after they are more mature.

While Chair Clayton did not specifically discuss registered funds and asset managers in relation to his vision for capital markets reform, they could be critical facilitators of capital markets access. According to the [2017 Investment Company Fact Book] ("Fact Book") published by the Investment Company Institute ("ICI"), more than 93 million Americans (44% of U.S. households) have invested over $19 trillion in mutual funds and exchange-traded funds ("ETFs"). Registered funds and their managers operate under heavy regulatory burdens that have only increased in recent years. Accordingly, Chair Clayton's stated principle of ensuring that all Americans have the opportunity to participate in capital markets certainly would be furthered by supporting reforms for registered funds.

Reduce Burdens on ETFs

One possible set of reforms for Chair Clayton to consider relates to exemptive relief requirements and listing standards for ETFs. ETFs are one of the fastest growing types of registered funds, with total net assets increasing almost eight-fold in the past ten years, to nearly $4 trillion according to recent reports. However, much of that growth has been concentrated in a handful of key industry players, at least partially as a result of the high regulatory barrier to entry into the marketplace caused by existing regulations.

One significant barrier to entry is that ETFs currently require exemptive relief from the SEC in order to operate. Historically, most ETFs that received exemptive relief have tracked a specific index of securities (such as the S&P 500). More recently, the SEC has granted relief for actively managed ETFs that meet certain conditions. The exemptive order process can be expensive and time consuming. While the SEC proposed some rules to govern ETFs in 2008, no rules were ever adopted. The time is ripe for the SEC to adopt exemptive rules that would allow ETFs that generally meet the conditions in typical ETF exemptive orders to operate without obtaining an exemptive order.

1. On May 9, 2017, Chair Clayton filled the first of those vacancies, the position of Director of Corporation Finance, with retired Simpson Thacher partner William Hinman.

Another key regulatory burden for ETFs relates to listing standards. As ETFs are listed on securities exchanges, they must meet the listing standards of an exchange in order to list. The SEC has approved generic ETF listing standards for various exchanges that allow listing of index ETFs, and recently, actively managed ETFs, that meet the generic standards at the time of listing. For ETFs that do not meet the generic standards, an exemptive order must be obtained from the SEC in order for the ETF to list. However, in 2016 several securities exchanges approached the SEC for approval of continuous listing standards, which impose ongoing requirements for ETFs. Industry advocates failed to convince the SEC that many of the ongoing requirements would impose significant new compliance burdens on ETFs, which would be difficult to implement and likely would raise the cost of ETFs. In addition to increasing the cost of investing in existing ETFs, the new continuous listing standards may add another barrier to entry for new ETFs. The continuous listing standards go into effect later this year.

Given the increasing extent to which retail investors have demonstrated familiarity and comfort with the structure of ETFs, reducing barriers to entry into the space would clearly further Chair Clayton's goal of improving access to capital markets.

Increase Retail Investor Access to Private Companies

Another way for Chair Clayton to expand retail investor access to growing companies would be to make it easier for them to seek investment exposure to private companies. Currently, retail investors can gain access to investments in private companies through registered funds that invest in hedge funds and private equity funds, but the SEC generally requires that such funds only be offered to "accredited investors." Individual investors must have earned $200,000 in annual net income in the past two years or hold $1 million in net worth, excluding their primary residence, to meet the accredited investor standard. While it is understandable that the SEC would want to ensure that investors in such funds are sophisticated enough to understand, and wealthy enough to bear, the risks associated with the types of investments that hedge and private equity funds make, this high qualification hurdle obviously reduces the ability of retail investors to gain exposure to private companies through registered funds of hedge funds and private equity funds.

We acknowledge that while simply lowering the bar for retail investors to invest in funds that invest in hedge funds and private equity funds is one way to improve access to private companies, the SEC may have significant concerns about appropriate safeguards to prevent end runs around the statutory constructs for private funds. That said, the SEC also could make it easier for retail investors to invest in private equity or hedge-like investments without raising such concerns. Specifically, by permitting registered funds to co-invest more efficiently in transactions alongside private funds, the SEC could meet Chair Clayton's goal of providing access to retail investors to younger companies while not undermining important investor protection concerns. Currently, SEC no-action guidance allows registered funds to co-invest alongside private funds if the only term being negotiated in the transaction is price. In any other scenario, including most types of investments in private companies, a registered fund may need an exemptive order from the SEC, which is a costly and time-consuming proposition. An exemptive rule under Section 17 of the Investment Company Act of 1940, as amended ("1940 Act"), allowing additional types of co-investments, or even codifying the exemptive relief that has been granted to several companies, would immediately enhance retail investor access to private companies. Because the existing exemptive relief requires that funds not be disadvantaged vis-à-vis private funds with which they co-invest, such a change would also be consistent with the SEC's mission to protect investors, maintain fair, orderly, and efficient markets and facilitate capital formation.

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These are just two potential ways that Chair Clayton's goal of increasing access to capital markets could tie in with reforms for registered funds. Indeed, we believe that, given the role of registered funds in the savings, retirement and investment accounts of retail investors, the SEC would be well-served to focus on registered funds in the coming years as a primary driver to bring Chair Clayton's goals to fruition.

The Time is Ripe to Re-Evaluate the Burden on Registered Fund Directors

Because mutual fund boards oversee an outsourced business model – i.e., because all actions taken on behalf of a fund are by agents, not employees – a mutual fund board is by design an oversight board. As such, day-to-day management of actions taken by those agents, such as the investment adviser, administrator or distributor, is not properly within their purview. Given this design, a classical view of the role of the fund board is one that focuses on oversight of conflicts of interests between the funds they oversee and those agents that have contractual relationships with the funds.

Historically, this conflict of interest view has been embodied in both the statutory design of the 1940 Act and the rulemaking thereunder. For example, directors are charged with reviewing advisory contracts on an annual basis under the 1940 Act, and for blessing affiliated cross-trades under a rule under the 1940 Act. Over time, however, the SEC has placed growing responsibilities on directors of registered funds. In some cases, these responsibilities relate to conflicts of interest oversight. In others, these responsibilities veer closer to day-to-day management. The responsibilities that boards feel they must shoulder sometimes stem from exemptive orders, informal Staff guidance, administrative actions or even speeches or remarks by SEC officials. Even if one were to grant *arguendo* that each responsibility placed on a fund board is appropriate, in the aggregate the sheer volume of these requirements impedes a fund board's ability to focus on the key issues that it was intended to handle.

Industry groups, and the SEC, seem to recognize that it may be time to revisit some of the requirements imposed on fund directors.

Time for the SEC to Take Action

It has been 25 years since the Division of Investment Management (the "Division") issued a formal report that included recommended reforms regarding the role of fund directors. In framing its recommendations, the report noted that "in order to allow directors to devote their time and attention to truly important matters, we believe that provisions that require directors to conduct reviews and [make detailed] findings that involve more ritual than substance should be eliminated." Nine years ago it appeared as though the Division was on a path to produce a similar report based on the "Director Outreach Initiative" during which the Division's then Director, Andrew J. Donohue, attended numerous meetings with fund boards and received many comments from various stakeholders on board responsibilities. Unfortunately, unlike the previous initiative in 1992, no formal report was issued as the financial crisis quickly diverted the Division's attention to more immediate and urgent matters. During the ICI's annual mutual funds conference in March 2017, Amy Lancellotta, Managing Director of the Independent Directors Council ("IDC"), indicated that the IDC intended to push the SEC to revisit and publish a report building off of the Division's work during Mr. Donohue's tenure.

It appears as though the Division may finally be moving toward taking some action to reduce the burden on directors. Shortly after Ms. Lancellotta's remarks, during the Practicing Law Institute's Investment Management Institute in March 2017, the Division's current Director, David Grim, responded to a question regarding reassessing board responsibilities by stating:

> " … One of the … great developments in the asset management industry has been the compliance rule and what it has spawned in terms of enhanced compliance within the industry and in certain targeted ways I think … we've kind of tried to calibrate things where the board role recognizes the existence of the CCO and the compliance rule. But a lot of our rules predate the existence of the compliance rule around board obligations and so I think this is an important topic for IM and potentially for the Commission to spend some time thinking about and try to see if we can come up with ideas to enhance the way boards oversee funds."

To the extent that the Division is actively considering reducing the burden on fund boards, it should begin with the still-relevant recommendations of the IDC and the Mutual Fund Directors Forum (the "MFDF") made in 2008 in response to the earlier Director Outreach Initiative.

In a 2008 letter to the Division, the IDC raised points similar to Mr. Grim's recent remarks. In particular it stated, "[i]n many instances, the matters are already being well handled by the fund CCO, and board-level review has become an unnecessary and duplicative layer on a well-functioning system." As a result, the IDC made specific recommendations for Rules 10f-3, 17a-7, and 17e-1 under the 1940 Act that would (i) shift review of quarterly reports to a person designated by the board (such as an employee of the investment adviser), rather than to the board itself and (ii) allow a designee to approve changes to the policies and procedures under such rules and report material changes to the board. Similarly, the IDC suggested that a board did not need to receive reports under Rule 17f-5 (foreign custody), but rather such reports should be provided to a designee. The IDC also recommended that the requirement under Rule 22c-1 that a board set the time or times during the day that a fund's net asset value is computed be reassigned to the fund's investment adviser. Finally, the IDC also commented on what must be discussed in shareholder reports regarding the factors that form the basis for a board's approval of an investment advisory contract. Specifically, it advised eliminating the discussion of whether a board relies upon comparisons of the services to be rendered and the amounts to be paid under an investment advisory contract with those of other types of clients, such as pension funds or separately managed accounts. The IDC argued that these comparisons may not be relevant to a board's consideration of a fund's investment advisory agreement but still require time and resources to address during the Section 15(c) process.

In addition to the IDC's efforts, the MFDF offered several recommendations in its own 2008 letter sent in response to the Director Outreach Initiative. It identified a number of responsibilities that were potentially too detail-oriented (to the point of possible distraction), such as (i) the quarterly review of amounts expended under Rule 12b-1 plans, (ii) the mechanics of making fair value determinations and (iii) review of routine transactions involving certain affiliates. The MFDF believed that these burdens could be reduced by either (i) eliminating or scaling back these requirements or (ii) providing boards with more freedom to delegate, which would allow boards to "manage their own operations and focus on those areas and activities they believe provide the most benefits to their shareholders."

SEC Rulemaking Proposals Send Mixed Signals

While Mr. Grim's remarks indicate a potential willingness on the part of the SEC to reduce the burdens on fund directors, the SEC's 1940 Act rule proposals in 2015 and 2016 indicate otherwise. Rules and proposals regarding liquidity risk management and derivatives proposed to add specific duties to fund boards that either could fall appropriately under the framework of Rule 38a-1 (the compliance rule) or appeared to involve day-to-day management oversight. In commenting on the proposed derivatives rule, for example, the IDC and others took issue with several aspects of the proposed rule, including questioning the need for the board to approve specific policies and procedures or make determinations relating to portfolio management and investment risk management functions. The IDC argued that if a fund wanted to rely on the proposed rule, it would need to concurrently comply with Rule 38a-1 and adopt policies and procedures reasonably designed to prevent violations of the proposed rule and the board would be required to approve such policies and procedures and oversee compliance with them. As a result, mandating specific approvals under the proposed rule was neither necessary nor warranted. The MFDF echoed this sentiment in its 2016 comment letter and stated that by "imposing these duties directly, rather than making them subject to section 38(a) of the Act, the Commission appears to be suggesting that boards have a more direct role than just overseeing the fund's compliance with applicable laws."

As with proposed derivatives rule, the IDC and MFDF also took issue with certain aspects of the recently adopted "swing pricing" rule that they feared potentially placed additional management-like responsibilities on a fund board. Under Rule 22c-1, effective November 19, 2018, an open-end fund may, under certain circumstances, use "swing pricing" to adjust its current NAV per share for certain shareholders to mitigate dilution as a result of their purchase or redemption activity. However, for a fund to avail itself of this flexibility, its board must specifically sign off on a litany of items including (i) the swing pricing policies and procedures, (ii) the swing thresholds and upper limit on the swing factors used, (iii) designation to the fund's investment adviser or an officer responsible for administering the swing policies and procedures and (iv) reviewing no less frequently than annually a written report prepared by the designee who administers the swing policies and procedures. Consistent with its 2008 letter, in its 2016 comment letter regarding the swing pricing rule, the IDC recommended that while the board can oversee swing pricing processes, the investment adviser, rather than the board, should designate the person responsible for administering the swing pricing policies and procedures so as to avoid being drawn into management-level decisions. Similarly, in its 2016 comment letter, the MFDF encouraged the SEC to "assign directors a role that is consistent with their using their business judgment to oversee funds on behalf of the fund's investors and be careful not to give directors and boards operational-type responsibilities." A review of the adopting release for the swing pricing rule indicates that the SEC was not convinced by these arguments, and the board's responsibilities under the rule were largely adopted as proposed. With respect to the recently adopted liquidity risk management rule, however, similar arguments were at least partially accepted by the SEC, as the adopting release clarified that a board is responsible for general oversight, but not for changes to a liquidity risk management program or setting a fund's highly liquid investment minimum.

If the Division considers streamlining board responsibilities, it should not only begin with the still relevant recommendations of the IDC and MFDF made in 2008, but also consider the aggregate burden on boards in pending and future rulemakings. We believe a guiding principle for board oversight is one that requires board intervention primarily where there is a possibility of a conflict of interest between the interests of a service provider to a fund and the fund itself. Furthermore, such conflicts should be evaluated in light of the likelihood that such conflicts will disadvantage the fund, and not merely on the premise that a conflict could exist in theory where it will not in practice. We also observe that industry participants often resolve thorny regulatory issues by proposing to the SEC that, instead of prescriptive rules with respect to certain practices, the SEC should simply leave an issue to a board to oversee. It will be in the ultimate long-term interest of all industry participants, including the regulator, if boards are freed up to focus on the issues of greatest importance to fund investors.

Growing Academic Debate Over Antitrust Concerns Involving Asset Managers and Mutual Funds Piques Policymaker Interest, But Includes Impractical Proposals

In our November 2015 Alert, we highlighted two academic papers that raised antitrust concerns related to investments by mutual funds and asset managers in competitors within concentrated industries, such as the airline or banking industries. Currently, passive investors enjoy an exemption from the Clayton Act, which is one of the federal antitrust statutes, on the theory that a purchase of a security by a person for investment purposes – rather than for purposes of exercising control – does not give rise to anticompetitive concerns with respect to the portfolio company's industry. The academic papers laid the groundwork for questioning the availability of the passive investor defense for institutional investors, such as mutual funds and asset managers, based on the theory that they may not be truly "passive," and "horizontal ownership" could reduce the incentives for portfolio companies to compete (which could explain, for instance, the increase in fares in the airline industry).

Since we initially addressed the topic, additional academic papers have been published, both supporting and disputing the anticompetitive effect of such investments, and some policymakers have taken an interest in the issue. For example, Bill Baer, former Assistant Attorney General for the Antitrust Division of the Department of Justice, testified before a Senate subcommittee in March 2016 that the Department was "looking at" the issue of horizontal ownership in more than one industry. Additionally, SEC Commissioner Kara Stein specifically mentioned asset managers' ownership of competing companies as raising potential transparency and disclosure issues in her speech at the annual SEC Speaks conference, and Senator Amy Klobuchar (D-MN), ranking member on the Senate Antitrust Subcommittee, noted in a March 2017 speech that it is "easy to see" how such cross-ownership could hurt consumers.

This issue seems to have garnered attention from policymakers after the *New York Times* published an opinion piece in December 2016 by the authors of an academic paper that proposes restricting the ability of institutional investors to own stakes in competing companies in concentrated industries. Some have cautioned policymakers from relying on the early academic papers until further research is done. For example, BlackRock published a ViewPoint in March 2017, noting that the academic research ignored practical considerations and the realities of the asset management business. Additionally, an economic paper by Daniel P. O'Brien and Keith Waehrer published in February 2017 found several flaws in the early academic studies and argued that it is premature for policy to be made when much work needs to be done to demonstrate whether there may be a causal relationship between horizontal shareholding and decreased competition.[2] In this Alert, we address the policy proposal set forth in that *New York Times* opinion piece, and the underlying academic paper, which suggest imposing a limit on the ability of mutual funds and asset managers to invest in concentrated industries. Our view is that the proposal would create significant market risks that could outweigh any benefit.

Rise of Institutional Investors

The *New York Times* opinion piece and academic paper by the same authors note that institutional investors, including asset managers and mutual

2. The authors of this economic paper acknowledge that the ICI partially funded their research, without substantive input.

funds, own approximately 70% of U.S. publicly traded stocks, whereas in 1950 that figure was 7%. The authors also state that the rise of the institutional investor has "undercut middle-class living standards." What the authors fail to note, however, is that a large part of this growth is due to the fact that mutual funds are now owned by average investors. According to the ICI's Fact Book, over 44% of U.S. households own investment companies (up from 4.6% in 1980), and retail investors own 89% of fund assets. Among households that own mutual funds, 51% have household incomes of less than $100,000 and 89% have household incomes of less than $200,000.[3] Since 1980, the percentage of household assets held in mutual funds has increased from 3% to 22%. As the industry has grown, fees and expenses have shrunk, falling by 36% in this century. In other words, average retail investors have drastically increased their reliance on mutual funds to access investment opportunities, and those investment opportunities are available to such investors in increasingly cost-effective ways.

> *"Institutional investors, including asset managers and mutual funds, own approximately 70% of U.S. publicly traded stocks, whereas in 1950 that figure was 7%."*

The Policy Proposal

Academics Eric A. Posner, Fiona Scott Morton and E. Glen Weyl authored an academic paper in November 2016, and the opinion piece referenced above, in which they essentially propose that mutual funds and asset managers be limited to either (i) investing in only a single issuer within a concentrated industry or (ii) owning less than 1% of the total size of a concentrated industry. Based on recent academic papers, examples of potential "concentrated industries" include the airline and banking industries. The proposal would apply the 1% industry cap to an asset manager's clients in the aggregate, meaning that all of the registered funds in a fund complex would have to share that 1% exposure with any private clients (but there would be no cap if all clients were invested in a single issuer from that industry).

3. While there is no formal definition of "middle-class," the Pew Research Center has used the range of two-thirds to double the national median income, adjusted for household size. For example, based on 2014 data, a four-person household would be deemed "middle-class" if its income ranged from approximately $48,000 to $144,000.

Impact on Diversification and Index Funds

The authors acknowledge that their proposal could be interpreted as conflicting with modern portfolio theory and the widely accepted principle that diversification, which reduces exposure to individual issuers, is a key component of smart investing and risk management. However, the authors downplay the cost of the reduced diversification as "minimal." BlackRock, in its ViewPoint piece, took issue with this characterization of the costs of reducing diversification. For example, BlackRock points to a comparison of the annualized return and volatility of various sectors against the single issuer with the largest market capitalization in each sector as an illustration of how investing in a single issuer generally presents greater volatility risk and does not always mirror the sector's investment performance.

In their opinion piece, the authors of the proposed restrictions unwittingly provided the perfect example of why diversification is important:

> "Large institutional investors could still provide cheap, diversified mutual funds to consumers under our proposal because the benefits of diversification within an industry are tiny compared with diversification *across* industries. A fund owning United Airlines can diversify with holdings in Walgreens; it does not need to own Delta as well."

As recent incidents involving United Airlines have shown, concentration in a particular issuer can be extremely risky and subject investors to increased volatility. United Airlines' stock price reportedly fell as much as 6.3% in a single day after a passenger was forcibly removed from a flight and disturbing footage of the incident spread virally across the internet and media outlets. Similarly, a large national bank recently saw its stock price decline to an even greater degree in the wake of a regulatory enforcement matter and accompanying negative media coverage. If an investor needed to redeem their investment in an index fund, particularly one that focuses on the financial sector, shortly after those incidents, the value of their investment would have been significantly lower if the fund were concentrated in the bank or airline in question rather than one that was truly diversified. Further, as noted above, funds concentrated in a single bank or airline may not have been able to exit their positions, and if they were able to, might have theoretically created extraordinary downward pressure on the issuer's stock price.

The authors also appear to acknowledge that their proposal would disproportionately affect funds that seek to track an index of securities. Index funds are widely regarded as a low-cost way for retail investors to diversify their portfolios and gain exposure to broad market sectors. Many of the market's largest index funds are run by the largest asset managers, several of which manage in excess of a trillion dollars of client assets. If these large index fund managers had to comply with the proposed restrictions, absurd results would occur. Index funds that track the S&P 500 Index currently invest more than 5% of their assets in banks to track the weighting of the index. If all bank holdings for these managers' clients needed to be concentrated in a single issuer, the largest S&P 500 index fund currently offered would need to invest upwards of $10-12 billion in a single bank. Further, if the manager's other clients wanted exposure to the banking industry, that concentrated exposure would be much higher, and may even result in the manager's clients holding a significant, and possibly even a controlling, position in the issuer. For example, if a hypothetical manager's clients, in the aggregate, were to own 5% of each of the ten largest airlines, consolidating those positions into a single issuer could result in the manager's clients owning 30, 40 or even 50% (or more) of one airline. Not only would that mean that the asset manager could no longer be treated as a "passive investor" for antitrust purposes, but in that scenario the asset manager's fiduciary duties to its clients might require it to take an active role in the airline's management. Additionally, a fund so concentrated in an issuer could face significant obstacles to divesting its position to meet redemption requests or to shift assets to another issuer in the same industry, including Securities Act of 1933 restrictions on the ability of large shareholders to dispose of their positions.

This example raises another issue that would arise under the proposals. A large part of the reason index funds are low-cost investment options is that investment decisions are largely pre-determined, as the fund tracks its index and does not require significant active management with respect to its investment portfolio. In a world where an index fund might be limited to a single issuer in a given industry in order to track the exposure of its index, managers would presumably, in the exercise of their fiduciary duties, need to conduct research and diligence to invest in the issuer that they believe is the best investment for the fund. This likely would result in increased costs for index funds.

While it remains to be seen whether further study finds any measure of causality between horizontal shareholding and competition in concentrated industries, the policy proposals put forth thus far are not the answer, as they could have disastrous effects on equity markets and reduce access to investment opportunities for average retail investors.

SEC Publishes Risk Alert on Top Five Investment Adviser Compliance Issues Found During Inspections

In February the Staff of the SEC's Office of Compliance Inspections and Examinations (the "OCIE Staff"), issued a National Exam Program Risk Alert ("Risk Alert") presenting the five compliance topics most frequently identified in deficiency letters that were sent to SEC-registered investment advisers. The Risk Alert sampled over 1,000 examinations of SEC-registered investment advisers conducted over the two years prior to its release. The deficiencies and weaknesses concerned certain requirements of the Investment Advisers Act of 1940, as amended, related to:

- compliance requirements under Rule 206(4)-7;
- required regulatory filings;
- custody requirements under Rule 206(4)-2;
- code of ethics requirements under Rule 204A-1; and
- books and records requirements under Rule 204-2.

Although the Risk Alert is focused on investment advisers, boards and investment advisers of registered funds should be aware of these issues.

Compliance

The Risk Alert highlighted a frequent lack of attention to maintaining up-to-date and tailored compliance policies. Specifically, the OCIE Staff detailed the frequent occurrence of compliance manuals that are "off-the-shelf" template manuals. These types of manuals generally are not reasonably tailored to the investment adviser's business practices because they fail to take into account important individualized business practices such as the investment adviser's particular investment strategies, types of clients, trading practices, valuation procedures and advisory fees. Relatedly, many such policies are not reviewed annually or updated in response to changes in strategies, personnel or applicable regulations. As registered funds are required to adopt compliance policies and procedures under Rule 38a-1, and the SEC is increasingly requiring specific policies and procedures under new SEC rules, such as the recent liquidity risk management rule, it is important for an investment adviser to have an established process for developing and updating its compliance manual to ensure it is appropriately tailored to its business. Similarly, boards are required to approve compliance policies and procedures and should have an understanding of the investment adviser's process.

Regulatory Filings

With respect to regulatory filings, the Risk Alert focused on inaccurate disclosures and untimely amendments to disclosures. The OCIE Staff noted that investment advisers made inaccurate disclosures on Form ADV Part 1A or in Form ADV Part 2A brochures, such as inaccurately reporting custody information, regulatory assets under management, disciplinary history, types of clients and conflicts. Many investment advisers also failed to amend promptly their required disclosures as a result of material changes.

Custody

The OCIE Staff found that investment advisers frequently did not recognize that they may have custody as a result of having (or related persons having) powers of attorney authorizing them to withdraw client cash and securities, including when investment advisers or their related persons served as general partners of pooled investment vehicles, or having access to online accounts using clients' personal usernames and passwords. The Risk Alert also highlighted that for many firms, surprise audit examinations did not meet the requirements of the custody rule, for technical reasons and also because surprise examinations were not actually being conducted on a "surprise" basis (e.g., exams occurred during the same month every year). The Risk Alert highlights that custody issues continue to be a focus of OCIE Staff, several years after the Madoff scandals, and this focus almost certainly carries over to examinations of registered funds.

Code of Ethics

The OCIE Staff reported that many investment advisers' codes of ethics were deficient because they failed to identify all access persons, specifically call for review of holdings and transactions reports submitted by access persons, or did not identify the specific submission deadlines for such reports, as required. Further, the Risk Alert observed that certain access persons submitted transactions and holdings less frequently than required and that many investment advisers' ADVs did not include descriptions of the firm's code of ethics.

Books and Records

The Risk Alert observed that certain investment advisers had errors and omissions in their books and records, such as inaccurate fee schedules and client records or stale client lists. Additionally investment advisers commonly failed to maintain all the books and records required by the rules, such as trade records, advisory agreements and general ledgers.

Takeaways

The findings of the Risk Alert are helpful in understanding the issues on which the SEC is currently focused. Investment advisers, whether or not they have been examined, would be well advised to review their policies and practices and in light of the Risk Alert's findings. Further, the Risk Alert can be useful in reviewing a registered fund's compliance as well. Funds have many similar requirements under the 1940 Act and, as a result, have their own policies and procedures that should be reviewed. Though they are separate from the investment adviser's policies, they generally are administered by the fund's investment adviser. If the investment adviser has issues with its own policies, it's possible that such issues could impact any funds managed by the investment adviser as well.

M&A Transactions

Acquiror	Acquired or Target Company	Type of Transaction and Status
Adviser Investments, LLC, a money management firm with approximately $4.5 billion AUM	**Braver Wealth Management, LLC**, an investment management firm with approximately $200 million AUM	Acquisition (terms not disclosed)
Alger Associates, Inc., the parent company of Fred Alger Management, Inc. with approximately $19.5 billion AUM.	**Weatherbie Capital, LLC**, a specialized growth equity manager with $800 million AUM	Acquisition (terms not disclosed)
BlackRock, Inc., an investment management company with approximately $5.1 trillion AUM	**First Reserve Infrastructure Funds**, the equity infrastructure franchise of First Reserve with approximately $3.7 billion AUM	Acquisition (terms not disclosed). Expected to close by the end of second quarter 2017
Cantor Fitzgerald Investment Advisors, L.P., an investment advisory firm owned by Cantor Fitzgerald L.P.,	**Efficient Market Advisors**, an asset management firm with approximately $1.1 billion AUM	Acquisition. Efficient Market Advisors will become a division of Cantor Fitzgerald Investment Advisors, L.P.
Citadel Finance SA, is a wealth management firm with approximately $25 billion AUM	**Trillium SA**, a boutique independent asset management firm with approximately $2 billion AUM	Acquisition (terms not disclosed; Citadel Finance and Trillium will continue to operate as two separate entities.)
Congress Asset Management, an investment management firm with approximately $8.1 billion AUM	**Century Capital Management**, a registered investment adviser with approximately $670 million AUM	Acquisition (terms not disclosed)
First Midwest Bancorp, Inc., a financial institution with approximately $9.5 billion AUM	**Premier Asset Management, LLC.**, an investment advisory firm with approximately $550 million AUM	Acquisition (terms not disclosed)
Fifth Third Bank, a diversified financial services company with approximately $27 billion AUM	**Retirement Corporation of America**, a retirement planning firm with approximately $500 million AUM	Acquisition (terms not disclosed)
Focus Financial Partners, a partnership of independent wealth management firms with approximately $60 billion AUM	**Crestwood Advisors**, an investment advisory firm with approximately $587.5 million AUM	Acquisition (terms not disclosed)
Goldman Sachs' Petershill II, LP, an alternative capital vehicle owned by Goldman Sachs Asset Management International Ltd with $262 billion AUM, and Wafra Investment Advisory Group, Inc. which is owned by the Public Institution for Social Security of Kuwait with $15 billion AUM	**Arclight Capital**, a private equity firm with $9.62 billion AUM	Acquisition of minority stake (terms not disclosed)

M&A Transactions *(continued)*

Acquiror	Acquired or Target Company	Type of Transaction and Status
HNA Capital, a part of HNA Group with approximately $90 billion AUM and RON Transatlantic Holdings'	**SkyBridge Capital**, a fund-of-hedge funds managing firm with approximately $12 billion AUM	Acquisition of majority stake (terms not disclosed)
Marble Point Credit Management LLC, an alternative asset manager with approximately $3.6 billion AUM	**American Capital CLO Management, LLC**, an investment firm with approximately $3.5 billion AUM	Acquisition. Marble Point and its affiliates received majority equity positions in seven of the eight CLOs managed by American Capital
New York Life Investments, the asset management arm of New York Life Insurance Company with approximately $93.7 billion AUM	**Credit Value Partners, LP**, a boutique investment advisory firm with approximately $1.91 billion AUM	Acquisition of majority stake (terms not disclosed)
OppenheimerFunds, a mutual fund manager majority-owned by MassMutual with approximately $232 billion AUM	**SNW Asset Management**, an independent firm focused exclusively on building and managing high quality fixed income portfolios with approximately $2.7 billion AUM	Acquisition (terms not disclosed)
Pine Brook, and investment firm with approximately $6 billion AUM	**Triumph Capital Advisors, LLC**, a credit investment firm with approximately $1.5 billion AUM	Acquisition (terms not disclosed)
Rosemont Investment Partners, LLC, a private equity firm	**Hartland & Co., LLC**, an institutional and wealth advisory firm with approximately $18 billion AUM	Acquisition of minority stake as part of a management-led recapitalization
Sanlam Emerging Markets, a subsidiary of The Sanlam Group with approximately $60 billion AUM	**PineBridge Investments East Africa Limited**, an asset managing firm with approximately $82.7 billion AUM	Acquisition of majority stake
SoftBank Group Corp., a multinational telecommunications and internet corporation with approximately $170 billion AUM	**Fortress Investment Group LLC**, an asset management firm with approximately $70.1 billion AUM	Acquisition. SoftBank has agreed to acquire Fortress Investment for approximately $3.3 billion in an all-cash deal.
South Street Securities Holdings Inc., a broker-dealer firm	**Lebenthal Holdings, LLC**, an asset management firm with approximately $1.426 billion AUM	Acquisition of 49% ownership interest in Lebenthal & Co., LLC and its 100% ownership interests in Lebenthal Asset Management, LLC and Lebenthal Family Office, LLC
Teton Advisors, Inc., a multi-strategy investment advisory firm with approximately $1.4 billion AUM	**Keeley Asset Management Corp.**, a privately owned asset management firm with approximately $1 billion AUM	Acquisition of certain assets (terms not disclosed)

Closed-End Fund Initial Public Offerings

Nuveen Preferred and Income 2022 Term Fund (NYSE: JPT)

Amount Raised (Inception Date):	$216 million $162.5 million (January 26, 2017)
Investment Objective/Policies:	The Fund's investment objective is to provide a high level of current income and total return. The Fund intends to liquidate and distribute substantially all of its net assets to shareholders on or before March 1, 2022. The Fund seeks to achieve its investment objective of providing a high level of current income and total return by investing in preferred securities and other income producing securities. The Fund will maintain a short to intermediate duration (including the effects of leverage) throughout its five-year term. The Fund's overall strategy seeks to mitigate the risk of rising interest rates both by limiting overall portfolio duration, and by investing a portion of assets in securities that have features (such as fixed-to-floating coupons) that are expected to reduce the impact of rising interest rates, and whose value may consequently fall less in rising interest rate markets than otherwise similar securities without such features. The Fund's portfolio will be actively managed as markets change and different opportunities arise to capitalize on the relative value opportunities of different instrument types, capital structure positions and related features, and to separately capitalize on the relative value opportunities of securities with different coupon structures.
Managers:	Nuveen Fund Advisors and Nuveen Asset Management
Book-runners:	Wells Fargo Securities, BofA Merrill Lynch and Nuveen Securities

BlackRock 2022 Global Income Opportunity Trust (NYSE: BGIO)

Amount Raised (Inception Date):	$210 million (February 28, 2017)
Investment Objective/Policies:	The Fund's investment objective is to seek to distribute a high level of current income and to earn a total return, based on the net asset value of the Fund's common, that exceeds the return on the Bloomberg Barclays 1-3 Month U.S. Treasury Bill Index by 500 basis points (or 5.00%) on an annualized basis over the life of the Fund, under normal market conditions. Because the total return of the Fund described in the Trust's investment objective is calculated based on NAV, it is measured after expenses. In accordance with its Agreement and Declaration of Trust, the Fund will terminate at the close of business on February 28, 2022 (the "Termination Date"). The Board of Trustees of the Fund may terminate the Fund, without shareholder approval, prior to the Termination Date; however, the Board does not intend to terminate the Fund earlier than August 31, 2021. The Board may also, without shareholder approval, extend the Termination Date by up to six months to a date on or before August 31, 2022 (which date shall then become the Termination Date). The Board may, to the extent it deems appropriate and without shareholder approval, adopt a plan of liquidation at any time preceding the anticipated Termination Date, which plan of liquidation may set forth the terms and conditions for implementing the termination of the Fund's existence, including the commencement of the winding down of its investment operations and the making of one or more liquidating distributions to common shareholders prior to the Termination Date. The Fund is not a target term fund and thus does not seek to return its initial public offering price of $10 per common share upon termination. The final distribution of net assets upon termination may be more than, equal to or less than $10 per common share.
Managers:	BlackRock Advisors, LLC, BlackRock International Limited and BlackRock (Singapore) Limited
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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Rajib Chanda is a Partner in the Washington, D.C. and New York offices of Simpson Thacher & Bartlett LLP. Rajib’s practice focuses on all aspects of issues facing registered investment advisers and sponsors of registered funds. Rajib has particular experience working with alternative asset managers seeking to access retail investor channels through mutual funds, business development companies, closed-end funds, exchange-traded funds and permanent capital vehicles. He also works extensively with more traditional registered fund sponsors and works closely with the firm’s asset management M&A group on transactions involving registered advisers and funds. In addition, Rajib provides counsel to boards of registered funds, and has substantial experience advising companies on issues relating to social media and cybersecurity.

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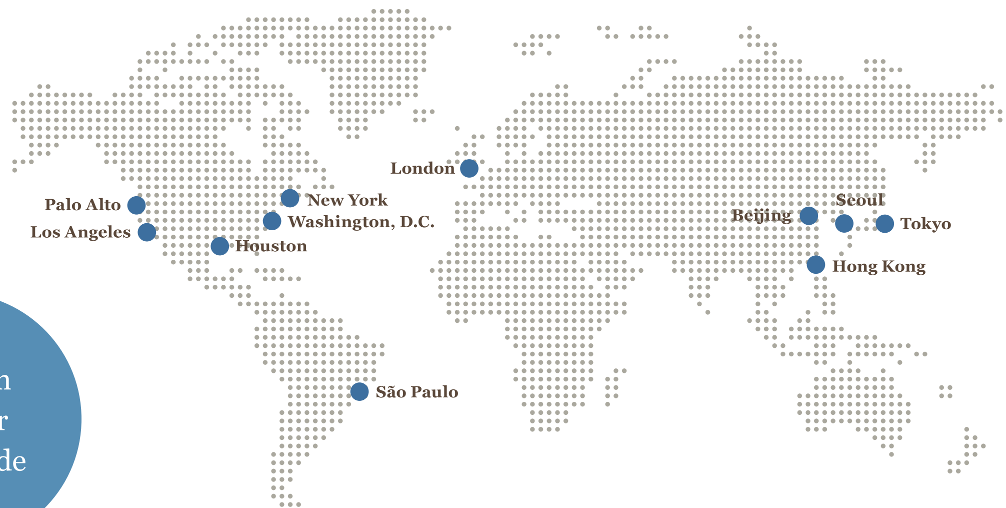

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