Simpson Thacher

Registered Funds Alert

May 2016

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This latest edition of Simpson Thacher's *Registered Funds Alert* discusses: the industry's response to a controversial proposal to restrict derivatives use by registered funds; the SEC's blessing of an expanded form of exemptive relief for registered funds to co-invest with affiliates; increased tension between SEC expectations for independent directors and their traditional role of oversight; and the SEC's framework for identifying and communicating changes in risks as a result of significant market events.

Industry Urges SEC to Consider Alternative Approaches to Derivatives Rule; Questions Appropriateness of Exposure Limits

As discussed in our last Alert, the SEC recently proposed new Rule 18f-4 (the "Proposing Release"), which is intended to restrict the use of derivatives by registered funds. As proposed, Rule 18f-4 would, among other things, require registered funds to adhere to one of two limits on derivatives use—an exposure- or risk-based limit. The exposure-based limit would prevent a fund from having aggregate exposure to (i) derivatives transactions (based on notional amount), (ii) "financial commitment transactions" (based on obligation amount) and (iii) any senior security (based on total indebtedness), totaling more than 150% of its net asset value. The proposed risk-based limit would allow a fund to have aggregate exposure of up to 300% of its net assets, so long as the fund's derivatives positions reduce the fund's overall value-at-risk ("VaR"). The Proposing Release also sets forth new asset segregation and risk management requirements. The SEC received more than 175 comment letters on the proposed rule, including a letter from Simpson Thacher.

This Alert summarizes notable themes presented in comments from industry participants. Similar to comments on the proposed liquidity rule, many industry commenters expressed support for the SEC as the appropriate regulator to address this issue (as opposed to the FSOC or another member of FSOC).[1] Commenters also generally expressed support for the consolidation and modernization of prior informal and formal guidance, such as Release 10666, into a single, uniform rule, noting that such a rule would bring more certainty, clarity and transparency to the obligations of registered funds.

Challenging the SEC's Economic Analysis and Assumptions

As an initial matter, the industry raised serious questions regarding the SEC's economic analysis and certain assumptions underpinning the proposed rule that arose from that analysis. The Investment Company Institute (the "ICI"), along with many others, urged the SEC to re-evaluate the impact of the proposed exposure- and risk-based limits in light of data submitted by commenters. While the SEC only analyzed approximately 10% of the industry in the Division of Economic and Risk Analysis white paper that accompanied the Proposing Release, the ICI analyzed data from 82 complexes with 6,661 funds and $13.6 trillion in assets under management (approximately 59% of the industry) and concluded that at least 369 funds, with $458 billion in assets under management either will have to de-register or substantially change their investment strategies to continue business as registered funds, with a particular disparate impact on alternative funds. Pointing to the ICI's study, many commenters indicated that the exposure limits proposed by the SEC should be re-examined, as it appears that the SEC underestimated the potential significant impact of these limits on capital markets and capital formation. Moreover, many commenters, including the International Swaps and Derivatives Association, Inc., also argued that the proposed rule should be tabled until the SEC is able to finalize and observe the effects, both independently as well as the cumulative burdens, of other recently proposed rules, such as the data reporting modernization rule, the liquidity risk management rule and its Title VII security-based swaps rulemakings.

369	$458 billion
Number of registered funds the proposed rule would require to either de-register or substantially change their investment strategies, according to an ICI study	Totals assets under management of affected funds

Proposed Alternatives and Revisions to the SEC's Exposure-Based Limit

Commenters raised several issues with the SEC's proposed exposure-based limit, including its reliance on notional amount and its seemingly arbitrary cap of 150% (or 300% in conjunction with the risk-based limit). A significant theme throughout the comments, including those submitted by Blackstone Alternative Investment Advisors LLC ("BAIA"), was that "notional exposure is an imperfect indicator of leverage and risk." A number of commenters cited to a recent white paper by James Overdahl of Delta

1. Notably, FSOC released an update on its review of asset management products and activities on April 18, 2016, in which it acknowledged the SEC's recent data reporting, liquidity and derivatives rulemaking proposals and appeared inclined to defer to the SEC's expertise in these areas.

Strategy Group, which discusses numerous ways in which notional exposure is a poor measure of risk. Accordingly, commenters suggested a number of alternative exposure limits based on metrics other than notional exposure for the SEC's consideration (which could be adopted in addition to the proposed 150% notional limit and make the proposed rule more appropriately tailored to funds that make significant use of derivatives). For example, BAIA recommended an exposure limit based on a fund's Portfolio VaR versus a multiple (e.g., 1.5x) of the VaR of a benchmark, such as the S&P 500 Index. In the BAIA formulation, a fund would be able to choose a benchmark with a VaR lower than that of the S&P 500 Index but could not choose a benchmark with a higher VaR.

> *". . . notional exposure is an imperfect indicator of leverage and risk."*

A significant number of commenters also suggested that, if the SEC proceeded with using notional values, notional values should be adjusted to reflect more accurately the risk of a derivative instrument's underlying reference asset. Commenters pointed out that risk-adjusted notional amounts have gained wide-spread acceptance from U.S. and foreign regulators in other contexts, such as swap margin requirements. For interest rate derivatives, commenters suggested duration weighting as a method of adjusting notional amounts to account for risk.

Additionally, commenters asked that the exposure limit of 150% be increased (e.g., the ICI suggested raising the limit to 200%) to provide funds with greater flexibility and mitigate the need for some funds to deregister or drastically modify their investment strategies. In this connection, it was pointed out that funds are likely to self-impose a lower exposure limit to avoid breaching the SEC's exposure limit.

Commenters also urged the SEC to expand the definition of netting when calculating the exposure-based limit. Under the proposed rule, funds would be permitted to net notional amounts of any offsetting derivatives transactions of the same type, with the same underlying reference asset, maturity and other material terms. For instance, Stone Ridge Asset Management LLC ("Stone Ridge") proposed that funds be permitted to net directly offsetting transactions that fall into certain specifically delineated categories. Finally, many commenters also recommended that the SEC allow for daily rather than time-of-transaction compliance monitoring. The proposed rule's real-time requirement would be especially problematic for multi-manager funds, where sub-advisers would be required to report portfolio limits or VaR in real time.

Alternatives to the SEC's Risk-Based Limit

Many commenters expressed the opinion that, as proposed, the risk-based limit is too narrow and would not serve as a realistic option for funds that use derivatives to gain market exposure. Among the alternatives proposed by commenters, OppenheimerFunds, Inc. suggested revising the risk-based limit by setting a VaR limit for a fund's overall portfolio based on a multiple of the fund's securities VaR (*i.e.*, the degree to which portfolio VaR can be increased through derivatives rather than looking at how portfolio VaR is reduced by derivatives). Under OppenheimerFunds's approach, a fund could have aggregate exposure of up to 300% of its net assets so long as its full portfolio VaR did not exceed 150% of its securities VaR—i.e., the fund's derivatives transactions could not create an additional risk of loss greater than 50% of the risk of loss without those derivatives transactions. The ICI submitted a different alternative, which would allow a fund to have up to 300% aggregate exposure (or 350% if the exposure-based limit is raised to 200%, as the ICI suggested), so long as the derivatives that make up the additional 150% serve to reduce the VaR of the rest of the fund's portfolio, including the derivatives that comprise the initial 150/200% of exposure. Thus, a fund could use derivatives for market exposure up to 150/200%, and any additional derivatives use would need to reduce risk.

Asset Segregation

A major theme throughout the comments was that the proposed exposure- and risk-based limits were unnecessary, and that the risks associated with a fund's derivatives use would be more appropriately addressed through asset segregation, in conformity with past SEC practice. The proposed rule requires that funds segregate "qualifying coverage assets," which involves different requirements for derivatives and financial commitment transactions.

With respect to derivatives transactions, funds would need to maintain assets on a daily basis with a value equal to the mark-to-market value on that day, plus an additional "risk-based coverage amount" that reflects an estimate of any additional amount the fund might owe if it were to exit the transaction under stressed conditions. With respect to financial commitment transactions, funds would need to maintain qualifying coverage assets equal to the amount of the obligations under such transactions, whether conditional or unconditional.

A significant theme in comments, including those from the Investment Adviser Association, was that the definition of "qualifying coverage assets," which generally limits qualifying coverage assets to cash and cash equivalents, should be expanded to include highly liquid assets with haircuts, noting that other U.S. and international financial regulators have blessed the approach. As argued by the ICI and many others, "restricting qualifying coverage assets to cash and cash equivalents can penalize investors by creating a 'cash drag' on the performance of a fund that otherwise would be fully invested." Further, many commenters also suggested revising the proposed rule to allow for netting derivatives transactions with offsetting exposures, with respect to both derivatives and financial commitment transactions.

BDC and Fund of Private Fund Issues

As proposed, Rule 18f-4 would apply equally to business development companies ("BDCs") and closed-end funds as to other types of funds, such as mutual funds. As noted in comments from the U.S. Chamber of Commerce, BDCs are a significant source of financing for small- and medium-sized companies in the United States, and it is well documented that financing for such companies has generally become less available in recent periods from banks for a variety of reasons, including regulatory changes. The proposed rule would drastically limit the ability of BDCs and certain closed-end funds (including real estate closed-end funds that make similar types of loan commitments with respect to underlying assets) to provide such crucial financing because it would treat revolving lines of credit provided by such funds as financial commitment transactions under the theory that they are unfunded commitments. In particular, Ares Capital Corporation ("Ares"), a specialty finance company that has elected to be regulated as a BDC, urged the SEC to exclude conditional loan obligations from the definition of a financial commitment transaction. Ares also suggested that, in the event that the SEC adopts the rule as proposed, it should expand the definition of "qualifying coverage assets" to include available capacity under a fund's revolving line of credit, which is typically balanced against a fund's unfunded commitments.

Several commenters, including the Private Equity Growth Capital Council (the "PEGCC"), raised concerns that the proposed rule's treatment of unfunded commitments to private funds as financial commitment transactions would unnecessarily diminish the ability of funds to invest in private funds. The SEC has allowed funds of private equity funds, for example, to operate so long as their investors meet certain sophistication criteria. Under the proposed rule, such funds would be required to segregate the full amount of all unfunded commitments to private equity funds, even if there is little to no chance that some of the commitments would be called. To illustrate this point, commenters compared two general types of investments that funds of private equity funds typically make—primary commitments to private equity funds that are in earlier stages of their life cycles and are more likely to call commitments to make new investments and secondary investments in later-stage private equity funds that are past their investment period and are highly unlikely to call any outstanding commitments. The PEGCC suggested that funds be required to segregate an amount based on a reasonable estimation of the amount of unfunded commitments expected to be called in the next calendar quarter instead of the full amount of the outstanding obligation.

Role of Board

The proposed rule would also impose on fund boards three primary new responsibilities: (i) approving one of the two portfolio limitations; (ii) approving asset segregation policies and procedures; and (iii) approving a derivatives risk management program (and any material changes thereto) and if applicable to the fund, approving the designation of a derivatives risk manager and reviewing quarterly reports regarding the program. A significant theme throughout the comments addressed concerns of the board's role exceeding typical oversight responsibilities. For instance, the Independent Directors Council (the "IDC") suggested that the board's approval of the particular limitation is not an appropriate board role, indicating that the adviser, if anyone, would be in the best position to make such a decision. Moreover, the IDC and Mutual Fund Directors Forum ("the MFDF") questioned the need for specific board approval requirements under the proposed rule when Rule 38a-1 already requires the board to approve compliance policies and procedures, including those related to derivatives. The MFDF and IDC both expressed concern that the approval of specific asset segregation policies and procedures might require board members to develop in-depth knowledge of VaR or other technical concepts beyond the scope of their typical oversight responsibilities. Finally, many also urged the SEC to decrease the frequency of the derivatives reports from at least quarterly to at least annually and to eliminate the requirement that a fund board approve any material changes to the fund's risk management program, especially given that Rule 38a-1 requires the fund's CCO report to address such changes.

Risk Management Program

Under the proposed rule, if a fund has more than 50% notional exposure to derivatives transactions, or engages in any "complex derivatives transactions" it would be required to adopt a tailored derivatives risk management program. A fund would be required to adopt certain policies and procedures reasonably designed to assess and manage the fund's derivatives transactions, and to ensure appropriate asset segregation. Additionally, a "derivatives risk manager" must be designated to administer the program.

Generally, most commenters did not oppose the SEC's proposal, but noted several modifications, including a cure period, a de minimis exception and the ability to appoint a committee or an individual as the fund's derivatives risk manager. Many commenters agreed that a cure period, for example the five-day period suggested by Guggenheim Investments, would be helpful for a fund that seeks to limit its exposure to derivatives to 50% or less of the net assets of the fund, but temporarily exceeds that threshold. The ICI also suggested a de minimis exception, whereby a fund would be allowed to use a de minimis amount of complex derivatives transactions without giving rise to the risk management program requirements. Many commenters, including BlackRock, also urged the SEC to allow firms to delegate the responsibilities of the derivatives risk manager to a group of people, such as a risk committee, noting that doing so "would allow firms some flexibility to incorporate the risk management program into their existing compliance and oversight structures."

Further, many commenters also asked the SEC to clarify that a fund's derivative risk manager will not be personally liable (or the target of any SEC enforcement actions) for any good faith decisions he or she makes in such capacity. Similarly, the derivatives risk manager should not be liable for the performance of derivatives transactions or their effects on a portfolio in the event that a decision ultimately turns out to be wrong.

Other Comments

Several commenters, including Simpson Thacher and Stone Ridge, asserted that "grandfathering" provisions should be incorporated into the rule for certain funds currently in operation, pointing to the significant startup capital and resources that have been expended by fund managers. Stone Ridge also urged the SEC to "embrace its ability to issue exemptive orders," arguing that any final rule should include specific exemptive authority by which a fund may be exempted from some or all of the requirements of the proposed rule. Noting that it is unlikely that any final rule would work for all funds, these commenters argued that a fund should be exempt from such requirements if it can demonstrate that its strategy does not implicate the SEC's concerns regarding excessive borrowing and undue speculation.

Simpson Thacher will be actively monitoring progress with regard to the derivatives and other proposals (including data reporting and liquidity management proposals) and will address any developments in future Alerts.

The SEC Grants Application for Broader, More Practical Co-Investment Relief

The Investment Company Act of 1940 has contained from its enactment a number of prohibitions on transactions between a registered fund and its affiliates, including prohibiting joint transactions that are disadvantageous to a registered fund participant. Over the past 25 years, the Staff of the Securities and Exchange Commission's Division of Investment Management has granted relief in the form of no-action letters from certain of these prohibitions by allowing registered funds to engage in "co-investment" transactions with their affiliates, so long as they comply with certain restrictive conditions. Under these no-action letters, a registered fund is permitted to co-invest alongside an affiliated entity in transactions involving publicly traded securities and in private transactions where there is no negotiation of a term other than price and allocations of such opportunities are made fairly and pursuant to board-approved policies.

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Of course, some private co-investment opportunities do require negotiation of additional terms other than price, and in certain instances registered funds have obtained specific exemptive relief from the SEC to enter into such transactions, subject to the conditions therein. Six years ago, Apollo Investment Corporation and its related entities ("Apollo") applied for such co-investment relief, but notably requested a modified version of the more "standard" relief that had been granted to other registered funds and their affiliates.[2] The Apollo application sought relief that would be more adaptable to the complex interactions between affiliates often encountered by larger asset managers with multiple types of investment product offerings. In late March 2016, after seven rounds of amended applications, the SEC granted Apollo's longstanding request. By granting Apollo's application the SEC has demonstrated that it may be open to reconsidering long-standing positions in order to provide more practical exemptive relief, if it reflects the realities of the asset management industry.

Until Apollo's application was granted, the typical application and order for co-investment relief has followed a virtually identical framework, regardless of the relative size, complexity, or sophistication of the applicant. The SEC has historically required 13 or 14 conditions that control how the applicant must behave with respect to sharing investment opportunities if they are to be granted the ability to allow registered funds to engage in co-investment transactions with affiliates. Generally, the conditions specify that all investment opportunities presented to an affiliated adviser that fall within a registered fund's investment objectives must be shared with the adviser of the registered fund so that the registered fund can make an independent decision about how much it will invest (i.e., quantity of securities to be purchased). Once all participating affiliated entities make their independent determinations as to quantity (as determined by the adviser to each participating entity), the transaction is processed centrally and allocated accordingly. If the requested quantity exceeds what is available, the investment opportunity is allocated among all of the co-investing entities on a pro rata basis, based on criteria specified in each application. Over three dozen applicants have received relief that follows this formula since the early 1990s.

Apollo's application followed the broad strokes of the standard framework, but it introduced several key changes to make the process more workable for large-scale operations and sought to expand the universe of allowable transactions further than what had previously been permitted by the SEC. Of particular note, Apollo sought to curtail the command that all investment opportunities within the scope of a registered fund's general investment strategy must be shared with that fund's adviser. Given the size and presence of larger asset managers, the proverbial firehose of investment opportunities that would have to be shared with the registered fund's adviser under the standard relief could quickly become prohibitively burdensome to evaluate. Apollo's solution was to create "Board-Established Criteria," which act as an adjustable filter to control the flow of investment opportunities presented to the registered fund. Apollo's application allows each registered fund's adviser the opportunity to recommend to the fund board criteria that describe the characteristics of potential co-investment transactions that are closely aligned with the registered fund's then-current focus, so that the fund may elect to request its adviser only be notified of matching co-investment opportunities. Apollo's application specifies that the criteria must be objective and testable, and that it must be approved by a majority of the independent directors of the fund's board before going into effect. Relatedly, Apollo also sought the flexibility for affiliated funds to close on co-investment transactions within 10 days of each other, provided they all commit on the same day.

The order also granted Apollo the ability to allow registered funds to co-invest in follow-on transactions even where the original transaction was not evaluated pursuant to the conditions of the relief. Under the standard relief, follow-on investments are arguably only permitted if the securities at issue were acquired in a co-investment transaction that was completed in compliance with the conditions of the exemptive order. For example, under the standard relief, if a registered fund and an affiliate separately acquired securities from the same issuer before exemptive relief was obtained and then a follow-on opportunity arises after exemptive relief was obtained, the registered fund potentially might not be able to participate jointly in the follow-on. Under Apollo's order, however, so long as the transaction is successfully put through an "enhanced review," a concept introduced by Apollo in its application, the registered fund may participate in the follow-on opportunity alongside affiliates. The enhanced review is a multi-step procedure that requires each registered fund's board to confirm, with the advice of independent counsel, the presence of certain conditions that are designed to ensure that the follow-on opportunity is fair, in the best interest of the registered fund, and otherwise in compliance with the 1940 Act.

Similarly, the Apollo order broadens the range of permissible joint dispositions to include those where the affiliated funds did not first obtain the securities in reliance on the relief. Under the Apollo order, should any affiliate elect to sell, exchange or otherwise dispose of securities also held by a registered fund, they must alert the registered fund's adviser of the potential transaction and the

2. An application for similar relief was filed by Ares on November 11, 2008. Ares filed an amendment on March 29, 2016 that closely tracked the final application submitted by Apollo. The SEC has not yet published a notice of an intent to grant Ares' application.

opportunity to participate proportionally. If the registered fund's adviser recommends joining the transaction, the registered fund's board must then complete an enhanced review of the transaction analogous to the procedure for follow-on investments described above.

In sum, Apollo's relief (and presumably Ares' soon to be granted relief) is broader and more scalable than the standard relief and is a better reflection of the realities facing certain types of larger asset managers. Though Apollo's application took six years to approve, and significantly longer than contemporaneous requests for the standard co-investment relief, the fact that the order was eventually granted is positive news and shows the SEC may be willing to engage with the industry to tailor exemptive relief to address specific needs. Whether this is indicative of a thaw in the SEC's general hesitancy to grant novel relief remains to be seen.

The SEC's Evolving Expectations for Fund Directors

Independent directors of registered funds are often referred to as "watchdogs" or, more recently, "gatekeepers," who guard the interests of shareholders against the concerns of conflicts of interest, self-dealing and other abuses that gave rise to the 1940 Act. The general consensus among both the industry and the SEC is that the role of independent directors is one of oversight. Reasonable minds disagree, however, on the meaning of "oversight," and the expectations that the SEC has for independent directors have evolved over time. As the SEC has grown to expect more and more of independent directors, it raises the question of whether there is a point where independent directors become too involved in day-to-day management, potentially decreasing the value of their oversight and jeopardizing their independent perspective.

The Role of the Board According to the 1940 Act's Legislative History

To establish a baseline of expectations for independent directors, it is helpful to look to the legislative history of the 1940 Act. There was significant discussion regarding the statute's requirement that independent directors make up a significant portion of a fund's board. The original draft of the statute would have required a majority of the board to be independent. The industry was very active in the process of revising the initial draft, and numerous industry representatives appeared before Congress to share their views and offer recommended changes. Many of these industry representatives were asked about their views regarding the statute's proposed requirement of having a majority of independent directors.

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While some argued that there was no need for independent directors, many acknowledged the value that independent directors would bring to the table. While generally supporting a requirement for independent directors, industry representatives rallied against the statute's proposed requirement that independent directors make up a majority of a fund's board. F. Wilder Bellamy, president of National Bond & Share Corporation (a closed-end fund) stated his view that independent directors should not control the board because shareholders are entrusting management, not outsiders, with their investments. Given the intent behind requiring independent directors, Mr. Bellamy stated that he believed that he did not "see any representation [of shareholder interests] that could be supplied by a majority that could not be supplied by a minority for, after all . . . the cold light of day is the thing that keeps people from doing things that are wrong. As a rule the minority directors can see that the light of publicity is turned on transactions just as well as the majority can."[3] This line of reasoning ultimately carried the day, as the statute was adopted with a requirement that independent directors comprise 40% of a fund's board.

3. *See Investment Trusts and Investment Companies: Hearings Before a Subcommittee of the Senate Committee on Banking and Currency*, 76th Cong., 3rd Sess. 423 (1940) (statement of F. Wilder Bellamy, President, National Bond & Shareholder Corporation).

As for the role of fund directors, Arthur Bunker, an executive vice president of The Lehman Corporation (one of the largest closed-end funds at the time) described it as follows:

> "I think it is fair to say that, in general, the function of the directors is to keep the company in contact with the outside world and to be responsible for the determination of general policy. In the matter of the investment company, this would mean that they would be responsible for such major questions as to the general program of acquisition or disposition of securities and, in a general way, for the determination of fields of investment.
>
> But this is a very different thing from asking them to pass upon every minute purchase and sale, to examine every report and recommendation made by the operating staff, and to consider every daily investment opportunity which may arise. I am sure you will agree that these distinctions between the operating staff and the directorship staff are fair distinctions.[4]"

Mr. Bellamy and others expressed similar understandings of the role of fund directors.

The SEC's Current Expectations Regarding the Role of Independent Directors

Fast-forwarding more than 75 years to the present, it is clear that fund directors are more involved in examining reports and recommendations of management than was contemplated in 1940. While prominent SEC officials such as Chair Mary Jo White and David Grim, Director of the Division of Investment Management, acknowledge the distinction between management and oversight, the SEC's rulemaking, examination and enforcement initiatives indicate that the SEC expects independent directors to get increasingly involved in overseeing day-to-day operations. The problem is that the line between oversight of day-to-day operations and actual management of such operations is thin and not always apparent. For example, commenters on the SEC's recent liquidity management and derivatives rule proposals have expressed concern regarding provisions that would require directors to approve detailed policies and procedures and evaluate key thresholds that appear to require technical knowledge and encroach upon day-to-day operations and responsibilities of a fund's adviser.

In a speech at the Mutual Fund Directors Forum 2016 Policy Conference, Chair White stated that certain recent events, including when a service provider was unable to calculate the net asset value of funds due to a computer glitch, "raise a number of new questions for fund directors related to their oversight of operational risks" and that directors should be "thinking about and asking fund managers whether these events could happen at your fund, how to prevent them from happening, and how to respond promptly and effectively if they do occur."[5]

The notion that independent directors bear some responsibility for oversight of operations issues demonstrates how far the 1940 Act framework, in practice, has drifted from the board being involved in "major questions as to the general program of acquisition or disposition of securities and, in a general way, for the determination of fields of investment." This is not to say that fund directors should shy away from asking fund management about these issues, but statements like Chair White's assume that directors have a responsibility to oversee day-to-day operational risks. It is not clear that fund boards are designed to do so, even if the SEC believes that it is their job to do so.

Concerns Regarding Potential Enforcement Actions Against Independent Directors

The disconnect between the SEC's expectations and the traditional role of the board opens the door for enforcement actions targeting independent directors. Chair White has put directors on notice, stating that "[w]hen directors fail to perform their duties, they should expect action to punish and deter such conduct."[6]

> *"The disconnect between the SEC's expectations and the traditional role of the board opens the door for enforcement actions targeting independent directors."*

At the same time, she expressed an expectation that independent directors need to develop (or hire) expertise in areas such as cybersecurity, derivatives, liquidity, trading, pricing and fund distribution. By expanding the scope of directors' responsibility to include day-to-day operations such as cybersecurity, trading and pricing, directors could be subject to additional enforcement risk. Anthony Kelly, co-chief of the Asset Management Unit of the SEC's Division of Enforcement, has stated that the SEC "anticipate[s]

4. *Id.* at 413 (statement of Arthur Bunker, Executive Vice President, The Lehman Corporation).

5. *See* Mary Jo White, Chair, SEC, The Fund Director in 2016: Keynote Address at the Mutual Fund Directors Forum 2016 Policy Conference (Mar. 29, 2016).

6. *Id.*

focusing on gatekeepers, and where appropriate, we will bring actions."[7]

In addition to the expanded scope of director responsibilities, fear of SEC enforcement targeting independent directors is further heightened by actions that indicate an apparent willingness on the part of the SEC to substitute its judgment for that of the board. A recent enforcement case cited by Chair White as a basic failure on the part of independent directors arguably illustrates that the SEC is willing to bring an action if it disagrees with the judgment of the independent directors. As discussed in a prior Alert, in the Commonwealth case, the SEC alleged that the independent directors failed to fulfill their duty under Section 15 of the 1940 Act to request and evaluate such information as "may reasonably be necessary to evaluate the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser." While the SEC acknowledged that the independent directors requested appropriate information from the funds' adviser, the alleged violation was that they did not follow-up with the adviser for information that was missing from the adviser's responses and therefore did not evaluate all information necessary to make a determination of whether to renew the advisory contracts. While as a general practice a fund board should seek responses to all information requested, it is notable in this case that the adviser was paid no advisory fees for the periods in question and much of the information alleged not to have been provided related to fee comparisons, profitability and economies of scale. It would not be unreasonable for independent directors to conclude that evaluating such information was not necessary to renew an advisory contract pursuant to which the adviser had not been paid any advisory fees.

Even more troubling are the mixed messages the SEC is sending regarding the expectation that independent directors are responsible for obtaining certain types of information from service providers even if they have no legal mechanism to compel them to provide it. In a January 2016 guidance update, summarized in our last Alert, the staff of the SEC's Division of Investment Management noted that independent directors have a Section 15(c)-like duty under Rule 12b-1 to request and evaluate all information reasonably necessary to consider approval or renewal of a Rule 12b-1 plan. In this respect, the staff stated its belief that independent directors should receive information from financial intermediaries with respect to distribution and servicing arrangements. Many industry observers have commented that boards have no mechanism to require financial intermediaries to provide such information, as they currently have no legal duty to do so. While some SEC officials, such as Division of Investment Management branch chief Thoreau Bartmann, have noted that the SEC recognizes that "there is a power imbalance" and that "intermediaries don't want to provide this information," other SEC officials have expressed a different view.[8] While speaking on a panel at the Practising Law Institute's 2016 Investment Management Institute in New York, Ken Joseph, Associate Regional Director of the Investment Adviser/Investment Company Examination Program in the SEC's New York regional office, stated that boards have an obligation to have adequate information no matter what. He expressed the view that "'I can't get the information' is not a valid excuse. . . there is no carveout in the federal securities law for 'I can't find the information' or 'they won't give it to me.'"[9] When considered in relation to the Commonwealth action, this statement demonstrates how the SEC's changing expectations may be putting directors between a rock and a hard place.

SEC Guidance Update Provides Framework for Evaluating and Updating Risk Disclosure

Following recent volatile markets and the SEC's ongoing concerns about fund liquidity risks, particularly in light of the dissolution of a high-yield open-end fund in December 2015, the staff of the SEC's Division of Investment Management ("Staff") issued a guidance update in March 2016 reminding fund complexes of their obligation to monitor market conditions and assess whether a fund's risk disclosure adequately reflects changing conditions ("Guidance Update"). The Guidance Update supplements prior guidance updates issued in recent years that highlighted the importance of summarizing principal risks in the prospectus and reevaluating fund names that suggest protection from loss.

The Guidance Update emphasizes the important role that full and accurate information about fund risks plays in allowing investors to make informed investment decisions. As a fund reacts to changing

7. *See* Greg Saitz, Intermediary Won't Give Up Info? SEC Feels Your Pain, Ignites, May 3, 2016.

8. *See id.*

9. *See* Greg Saitz, *No Excuses in Fight for Broker Information: SEC Official*, Ignites, Mar. 22, 2016.

market conditions, its risks are dynamic and may increase or decrease overall risk for investors at different points in time. Once-adequate disclosure may become inadequate, or risk disclosure may need to be added or moved to become more or less prominent. Consequently, the Guidance Update states that a fund (i) should review its disclosure risks on an ongoing basis to ensure that they remain adequate in light of current conditions and (ii) if any disclosure is inadequate, communicate any new or modified risks to investors.

The Guidance Update places emphasis on heightened responsibilities for a fund adviser in confirming that disclosures remain, in all material respects, accurate and complete in light of changing market conditions. Noting that many fund boards request that the adviser report on its process for preparing the fund's disclosure materials, the Guidance Update recommends that the adviser go one step further by providing information to the board on steps taken to evaluate fund risk disclosures and determine whether changes are appropriate.

The Staff states that funds should undertake three steps on an ongoing basis to assess and, if necessary, revise their risk disclosures to remain suitable in changing market conditions:

- Monitor Market Conditions and their Impact on Fund Risks. As part of day-to-day operations, funds should continually monitor market conditions and assess their impact on the fund and the risks associated with its investments.
- Assess the Adequacy of Risk Disclosures. Once a fund determines that changed market conditions have affected risks associated with the fund, it should assess the change's significance and materiality to investors. If it is significant and material, a fund should assess the adequacy of existing disclosures.
- Communicate with Investors: If the fund determines that changes to a fund's risks are material to investors and that the current disclosures are inadequate, it should update its communications and provide them to investors "at the time and in the manner required by the federal securities law and as otherwise appropriate."

The Guidance Update adopts an encouraging tone in discussing two evolving areas in which funds have provided "useful" information to investors regarding current market conditions. The first example relates to disclosures by certain fixed-income funds in response to potential changes in government policy that would raise the current historically low interest rates. In anticipation of such change many fixed-income funds warned investors of: (i) a possible decline in the value of fixed-income investments in response to higher interest rates; (ii) potential periods of volatility and increased redemptions; and (iii) the sensitivity of longer-term securities to interest rate changes. Secondly, in light of recent concerns over whether Puerto Rico would default on its debt, the Staff similarly commended funds with significant exposure to Puerto Rico debt for disclosing in their prospectuses that they invested in Puerto Rico debt, as well as the factors expected to impact the value of the Puerto Rico debt held by the fund.

While some in the industry have expressed concern that the Guidance Update will encourage funds to add technical risk disclosure about specific securities, an approach that the SEC expressly disavowed in the [1998 amendments to Form N-1A](), when read more generally, the Guidance Update seems to be focused on how significant or historic changes in market conditions can impact existing risk disclosure. The Guidance Update provides a framework for funds and advisers to utilize in evaluating risks and risk disclosure in connection with other significant market changes and events that may occur in the future (beyond interest rate and liquidity risks). Namely, a fund should (i) monitor market changes that may cause changes in a fund's susceptibility to risk and (ii) review and assess risk disclosures in light of these market changes, which requires evaluating whether that impact is both material and significant to investors. After employing the framework, a fund should look to the SEC's endorsements of the disclosure practices of fixed-income funds and those holding Puerto Rico debt in order to extrapolate how those practices would apply to the risk at hand. For example, the Staff approvingly cited a fund for looking toward the future and accounting for the interest of long-term investors by disclosing that interest rates are at historic lows and are likely to increase in the future, and explaining the potential secondary impacts that would affect a fund's fixed-income investments. The Guidance Update lays out a framework that may help funds and advisers struggling with whether to communicate a change in fund risk profile to investors.

M&A Transactions

Acquiror	Acquired or Target Company	Type of Transaction and Status
Affiliated Managers Group Inc., a global asset management company with equity investments in boutique investment management firms and approx. $619 billion AUM	**Ivory Investment Management LP**, an investment firm utilizing long-short equity and long-only investment strategies	Investment (terms not disclosed)
	Abax Investments (Pty) Ltd, an investment firm offering South African equity, fixed income, and strategic and tactical asset allocation strategies and a separate global equity strategy	Investment (terms not disclosed)
	Systematica Investments LP, an investment firm focusing on using science and technology in the investment process by implementing strategies such as trend-following and quantitative equity investing in both traditional hedge fund vehicles and liquid alternatives	Investment (terms not disclosed)
Financial Institutions, Inc., a provider of customized investment management, investment consulting and retirement plan services with approx. $1.2 billion AUM	**Courier Capital Corporation**, a registered investment adviser based in western New York	Investment (terms not disclosed)
BNY Mellon, a global investment company with approx. $1.6 trillion AUM	**Atherton Lane Advisors, LLC**, an independent registered investment adviser that focuses on wealth management and investment counseling for private clients with approx. $2.7 billion AUM	Acquisition (pending) (terms not disclosed)
Lightyear Capital, a private equity firm, and the **Public Sector Pension Investment Board**, a Canadian pension investment manager with approx. $112 billion AUM	**AIG Advisor Group, Inc.**, a network of U.S. brokers with more than 5,200 independent advisers and more than 800 full-time employees	Acquisition (terms not disclosed)
Legg Mason Investor Services, LLC, a global asset management firm with approx. $671.5 billion AUM	**Clarion Partners**, a real estate investment firm and registered investment adviser with more than 200 domestic and international institutional investors and approx. $40 billion AUM	Acquisition of 83% interest for $585 million (pending)
	Permal, a Legg Mason hedge fund manager, and **EnTrust Capital**, an alternative asset manager operating a fund of hedge funds platform with approx. $12 billion AUM	Merger (pending)
Delaware Investments, a global asset manager with approx. $165 billion AUM	**Bennett Lawrence Management LLC**, an investment manager focused on developing small- and mid-cap growth strategies with approx. $300 million AUM	Acquisition (terms not disclosed)
Financial Engines, Inc., a California-based independent investment adviser founded in 1996	**The Mutual Fund Store**, a registered investment adviser with approx. $9.7 billion AUM	Acquisition for $250 million cash and approx. 9.9 million shares of Financial Engines' common stock

M&A Transactions *(continued)*

Acquiror	Acquired or Target Company	Type of Transaction and Status
HarbourVest Partners, an independent, global private markets specialist	**BAML Capital Access Funds**, a private equity fund-of-funds manager and adviser	Acquisition (terms not disclosed)
PGIM, the investment management arm of Prudential Financial with approx. $963 billion AUM	**Deutsche Bank's Indian asset management business**	Acquisition (terms not disclosed)
Mercer Advisors, a wealth management firm with approx. $6 billion AUM	**Kanaly Trust**, provider of wealth management, financial planning and trusts-and-estates services to families, individuals and estates with approx. $2 billion AUM	Merger (pending)

Closed-End Fund Initial Public Offerings

Nuveen Municipal 2021 Target Term Fund (NYSE: JHA)

Amount Raised (Inception Date):	$81 million (January 27, 2016)
Investment Objective/Policies:	The Fund's investment objectives are to provide a high level of current income exempt from regular federal income tax and to return $9.85 per share to Common Shareholders on or about March 1, 2021. The Fund's subadviser seeks to identify relative value in the market and select municipal securities across diverse sectors that are underrated or undervalued. In seeking to return the target amount on or about the Termination Date, the Fund intends to utilize various portfolio and cash flow management techniques, including setting aside a portion of its net investment income, possibly retaining gains and limiting the longest maturity of any holding to no later than September 1, 2021. As a result, the average maturity of the Fund's holdings is generally expected to shorten as the Fund approaches its Termination Date, which may reduce interest rate risk over time.
Managers:	Nuveen Fund Advisors and Nuveen Asset Management
Book-runners:	Morgan Stanley, Bank of America Merrill Lynch, Wells Fargo Securities, and Nuveen 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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