Simpson Thacher

Registered Funds Alert

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The latest edition of Simpson Thacher's Registered Funds Alert discusses recent developments in the registered funds industry, including: the problem with fulcrum fees and a proposed potential alternative; a rule proposal that would modify the registration, communications and offering rules for BDCs and registered closed-end investment companies; and a recent development in co-investment exemptive relief application process.

After Nearly 50 Years, Fulcrum Fees Still Fall Flat

As active equity managers continue to lose retail inflows to passive investment vehicles, one approach some active managers have taken is to differentiate themselves on fees. Fulcrum fees, which adjust the adviser's compensation up or down based on the fund's performance, have been resurrected from near extinction and are now being heralded by some industry leaders and publications as the solution to active management's passive problem. We disagree.

The fundamental nature of fulcrum fees ensure that they will not work as a viable means to combat the erosion of market share driven by the increase in popularity of passive funds. Although in theory fulcrum fees better align the interests of active managers with the shareholders of funds they advise, in practice the implementation of a fulcrum fee is quite complex, and the logistical restraints involved ultimately do not allow the flexibility actively managed funds really need to compete with passively managed funds on cost. Moreover, the regulatory design of fulcrum fees in effect requires that investors be overcharged for mediocre performance.

We believe the industry would be better served by pivoting its attention towards advocating for Congress to allow advisers to registered investment companies the option to charge performance fees similar to those charged by private funds (referred to herein as "traditional performance fees"). There would of course need to be limitations on what types of performance fees advisers could charge and mechanisms to prevent reckless management, but decades of negotiations between advisers and sophisticated institutional investors in the private fund space have done an excellent job of providing guiderails for what those restrictions should look like if the concept of performance fees were imported to retail funds. A properly constructed traditional performance fee does not incentivize asset managers to take inappropriate risks, fairly compensates advisers for outperformance, and does not overcompensate for underperformance; all of which aligns the interests of retail investors with the interests of their advisers.

> *"We believe the industry would be better served by pivoting its attention towards advocating for Congress to allow advisers to registered investment companies the option to charge performance fees similar to those charged by private funds."*

In this Alert, we discuss why we believe the industry should move on from fulcrum fees as a potential savior and should instead focus on persuading Congress that it is time to revisit the ban on performance fees for registered investment companies.

The Active Versus Passive Problem

As it stands today, retail investors pay considerably more to invest in actively managed funds than passively managed funds, particularly with respect to equity funds, and that gap is due in large part to management fees charged by the advisers to the funds. The management fee pays for the adviser's cost of employing the portfolio managers who make the investment decisions. For active strategies, these management fees typically range from 0.5% to 2%, depending on the fund's strategy. For passive strategies, the management fees are far lower and typically range from 0.05% (or less!) to 0.25%.

Many investors would be happy to pay more for active management if it translated into better performance, but that often is not the case, especially for equity funds. Instead, while nearly all actively managed funds cost more than index funds, a smaller portion exceed their benchmarks. The reality is that it is difficult for investors to select fund managers that can reliably beat their peers and the index. And even when an investor makes the right selection and finds an active fund that beats the index, data shows that the manager's out-performance is unlikely to persist long-term.

And so the question is, how can actively managed funds bring their base costs down to compete with low-cost passive strategies when the fund does not beat its benchmark, but fairly compensate the adviser when the active strategy outperforms the benchmark? Many industry observers and participants are looking to fulcrum fees to answer that question.

This focus stems from the fact that fulcrum fees are, at present, the only type of performance-based fees that advisers may charge to most types of registered investment companies. Section 205(a)(1) of the Advisers Act generally prohibits registered investment advisers from charging a fee based on a share of capital gains on, or capital appreciation of, the assets of a registered investment company.[1] These types of compensation arrangements, referred to as performance fees, were prohibited to discourage advisers from taking "unnecessary risks" with client funds in order to increase advisory fees.[2]

Accordingly, the overwhelming majority of retail funds charge a "flat" management fee that is calculated as a percentage of the fund's average net assets and does not vary with performance.

However, in 1970 Congress created an exception to the performance fee prohibition, known as the "fulcrum fee." Under that exception, advisers may adjust their management fee based on performance so long as they do so symmetrically—meaning the fee moves up or down based on outperformance or underperformance relative to a benchmark index over a specified period. Congress felt that the symmetry of the fulcrum fee was appropriate for registered investment companies because it "would insulate investment company shareholders from arrangements that give investment managers a direct pecuniary interest in pursuing high risk investment policies."[3]

Nearly 50 years later, in the face of mounting fee pressure, some commentators are saying active strategies can be saved by setting fulcrum fees that start at a lower base rate than peer funds with flat management fees, but with the potential to earn the same or more as comparable active fund managers so long as they consistently outperform the benchmark. In this way, retail investors may be convinced that they are "paying for outperformance" and will be more tolerant of the comparatively high costs of actively managed funds.

There are numerous problems with this refrain. For one, there are serious and complex logistical difficulties in operating funds with fulcrum fee structures that make them unpalatable for advisers and potentially even detrimental to shareholders.

1. Advisers of registered funds and business development companies owned solely by "qualified clients" (as defined in Rule 205-3(d)(1) under the Advisers Act) are exempt from the prohibition on charging performance fees on capital gains or capital appreciation. Additionally, business development companies are exempt from the prohibition if as certain requirements set out in Section 205(b)(3) of the Advisers Act are met, including that the incentive fee on realized capital gains, computed net of all realized capital losses and unrealized capital depreciation, does not exceed 20%.

2. H.R. Rep. No. 2639, 76th Cong., 3d Sess. 29 (1940).

3. H.R. Rep. No. 1382, 91st Cong., 2d Sess. 41 (1970); S. Rep. No. 184, 91st Cong., 1st Sess. 45 (1969).

These are highly technical considerations that have been pointed out in numerous prior critiques of fulcrum fees and are beyond the scope of this article, but suffice it to say there are good reasons why there have been very few fulcrum fee funds historically. The bigger problem we see with the fulcrum fee as savior argument, is the fact that the symmetrical nature of a fulcrum fee model creates an inherent structural flaw that does not benefit shareholders.

Why Fulcrum Fees Fall Flat

To illustrate why many observers believe that fulcrum fees are the solution, consider a scenario where an adviser wants to create a new product that competes with other active products that typically have 1.25% flat management fees, and is willing to accept that it should only receive that 1.25% when it outperforms benchmarks by 5%.[4] Under the fulcrum model, the adviser might set a fulcrum fee rate of 1%, and a performance adjustment schedule with two breakpoints, reaching a maximum or minimum adjustment of 0.5% when the fund exceeds the benchmark by 10%. The expected management fee compensation would be as described in the chart below:

Relative Performance of the Fund to its Benchmark Index	Fulcrum Fee	Performance Adjustment	Total Management Fee
≥ +10%	1.00%	+0.50%	1.5%
+5% to +10%	1.00%	+0.25%	1.25%
-5% to +5%	1.00%	0.00%	1.00%
-5% to -10%	1.00%	-0.25%	0.75%
≥ -10%	1.00%	-0.50%	0.50%

Many have argued this scenario is a clear victory for shareholders and that this is how fulcrum fees will save active strategies, but this seems shortsighted. Yes, when compared to another active strategy with a flat 1.25% management fee, the hypothetical fulcrum fee model might well present a good value for investors. But offering a fee structure that is incrementally more shareholder friendly relative to other *active* funds does not address the active managers' real problem – index funds.

By and large, active strategies are losing out to passive strategies, and they are losing on cost. An investor that is already in the mindset and position of choosing between an actively managed fund or an index fund is focused on the relative expense of the fulcrum fee product compared to an index fund, not

4. The figures used in this and other examples are selected in large part for the computational ease of the hypotheticals. These precise figures may not necessarily represent commercially realistic scenarios, but we believe they do still illustrate the greater structural concern with fulcrum fees.

its cost compared to other active products. Under the hypothetical fulcrum fee model, a fund would still be paying a 0.75% management fee for performance that is 5% below the benchmark. That is, of course, more appealing than the prospect of paying a flat 1.25% for similar underperformance under a flat management fee structure. But from the perspective of an investor who is deciding between an actively managed fund and an index fund, paying 0.75% for performance that is 5% below the benchmark is still an abysmal prospect compared to paying far less for an index fund that by definition seeks to track the performance of its benchmark.

This outcome—where active managers are still relatively highly compensated for mediocre, or even poor, performance—is the both the key concern driving investors towards passive options and an inevitable result of the forced symmetry of fulcrum fees. Because the performance adjustment cannot increase more than it decreases,[5] even if an adviser wanted to be as aggressive as possible under a fulcrum fee model, the lowest possible fulcrum fee they could set would be halfway between 0% and the targeted fee for outperformance.[6] This is extremely problematic given that actively managed funds today often have management fees that are multiple times higher than those of index funds, and the problem is only being exacerbated as index funds continue to drive their management fees towards zero. So long as active funds are structurally saddled with a 200% maximum spread between baseline fees and outperformance fees, they will be prevented from truly competing with passive funds on cost if they want to earn a realistic fee for outperformance. Put simply, the Congressional design of fulcrum fees requires retail shareholders to overpay for bad performance in a foolish effort to incentive managers properly. The chart below shows the fee structure for the manager trying to be as shareholder-friendly as possible with a fulcrum fee still getting paid 62.5 basis points for performance that is 4.9% below the benchmark.

Relative Performance of the Fund to its Benchmark Index	Fulcrum Fee	Performance Adjustment	Total Management Fee
≥ +5%	0.625%	+0.625%	1.25%
-5% to +5%	0.625%	0.00%	0.625%
≥ -5%	0.625%	-0.625%	0.00%

Traditional Performance Fees Would Lead to Better Options for Retail Investors

Traditional performance fees would solve this fundamental problem with fulcrum fees by disconnecting the adviser's base compensation from its incentive to outperform the index, thereby allowing advisers to offer products that put the risk of failing to beat benchmarks on the adviser. Unlike fulcrum fees, traditional performance fees, such as those used by most private funds, are separate from the fund's base management fee. Under that model, a fund has a fixed base management fee, and then add an additional performance fee that it can earn for exceptional performance.

Decades of industry practice involving negotiations between sophisticated institutional investors and investment advisers have developed a set of features for modulating traditional performance fees that could be imported into the retail context and used to ensure retail investors are not exploited. Two features in particular, "hurdles" and "clawbacks," are common devices in performance fee structures that manage the adviser's risk tolerance while still incentivizing the adviser to meet a performance goal.

When a hurdle applies, no performance fee is paid unless the fund beats a specified performance threshold for the specific period. Many have hurdles that are based on a three year, twelve quarter, lookback period. This essentially means that that if the fund fails to meet its target at any point in the past three years, the fund will have to make up for that underperformance before the adviser can resume earning a performance fees. The potential for an adviser digging themselves into a hole that they will have to contend with for twelve quarters strongly disincentivizes unnecessarily risky strategies.

In the same vein, a clawback serves to protect a fund's investors from the possibility of either the fund not achieving its targeted return levels due to poor performance or the adviser earning more than is permitted. Essentially, if at the end of a

5. While there is guidance that suggests a fulcrum fee can be asymmetrical, it can only be asymmetrical such that the fee decreases faster than it increases. This would not resolve the problem, which is that advisers must set relatively high base management fees in order to realize the appropriate upside fees for outperformance.

6. Theoretically negative management fees would be permitted under the rule, but would likely be commercially impractical.

set period, the fund has not earned enough or the adviser has earned too much, the adviser may be required to pay part of its past compensation back into the fund. Though they accomplish it through different means, both hurdles and clawbacks achieve the same functional result as fulcrum fees, in that shareholders are not overcharged for mediocre long-term performance.

Utilizing these features, a traditional performance fee model could allow an adviser to offer an actively managed fund with considerably more variance between base compensation and total compensation than is currently permitted by the fulcrum fee model. Considering the same scenario as above where an adviser is seeking to earn 1.25% of net assets if it beats a benchmark by 5%, if traditional performance fees were allowed, an adviser could offer a product with a base management fee of 0.25%, which is competitive with index funds, but that also has a 1% performance fee with a hurdle of 5% over the benchmark, measured quarterly with a twelve quarter lookback period. If the fund only meets the benchmark, the adviser would only receive its base management fee, which would put investors in a position that is competitive with purely passive strategies. If the fund meets its performance target, the adviser would receive its 1% performance fee, and investors would be happy to pay it. If the fund underperforms the benchmark, the adviser's ability to earn performance fees in the future is reduced proportionately, thereby incorporating the same disincentive for risky strategies as fulcrum fees.

Relative Performance of the Fund to its Benchmark Index	Base Management Fee	Performance Fee (subject to a 5.00% outperformance hurdle)	Total Management Fee
≥10%	0.25%	+1.00%	1.25%
5% to 10%	0.25%	+1.00%	1.25%
-5% to 5%	0.25%	0.00%	0.25%
-5% to -10%	0.25%	0.00%	0.25%
≥ -10%	0.25%	0.00%	0.25%

The structural constraints on fulcrum fee models that make them inviable as solution to the passive problem are most apparent when fulcrum fee models are compared side-by-side with a fund using a traditional performance fee model.

In the more practical 1% fulcrum fee example, the potential to pay significantly more than an index fund for underperformance makes the fulcrum fee product almost as unattractive as regular flat management fee active funds. The improvement is marginal, and unlikely to sway the types of investors who are currently fleeing from actively

Relative Performance of the Fund to its Benchmark Index	Total Management Fee (1.00% Fulcrum Fee)	Total Management Fee (0.625% Fulcrum Fee)	Total Management Fee (1.00% Traditional Performance Fee with 5.00% Outper-formance Hurdle)
≥10%	1.5%	1.25%	1.25%
5% to 10%	1.25%	1.25%	1.25%
-5% to 5%	1.00%	0.625%	0.25%
-5% to -10%	0.75%	0.00%	0.25%
≥ -10%	0.50%	0.00%	0.25%

managed options. In the more aggressive 0.625% fulcrum fee example, the value proposition is better, but the potential cost for performance in line with the benchmark is likely still considerably more expensive than investing in a typical index option. Moreover, from a sheer practicality standpoint, it is unlikely that an adviser would consider it a sound business proposition to have the potential to earn 0% management fees for an actively managed product. Given that fulcrum fee products cannot effectively be structured to sway the types of investors that are actually leaving active management, and that they are likely to be less attractive commercial propositions than traditional retail funds with flat management fees, it is unsurprising that fulcrum fee funds remain rare, despite the recent uptick in their offering. A product that utilized a traditional performance fee, on the other hand, could effectively be structured to provide parity with a passive strategy when performance is similar, and compensate the adviser fairly for exceeding the benchmark, all without compromising investor protection.[7]

Conclusion

Fulcrum fees are interesting in theory, but a 50-year old solution is not the answer to a very modern problem. The shift towards passive strategies is driven, in large part, by the digital age making it relatively easy to track the market. As it stands today, professional fund managers, in the aggregate, control most of the money in the markets. Thus, it is unsurprising that index funds that track the overall movement of a market consistently do their task well. But what happens if active managers are driven out of the market by their inability to effectively compete with passive strategies on price? Eventually, the index becomes more and more a reflection of a few,

7. It may well be that for such a product to be commercially viable, the performance fee charged would have to exceed what would be charged by an active fund with a flat management fee structure. We do not believe this would materially change the analysis regarding the various approaches, as that flexibility still would not be available under the fulcrum fee model.

concentrated movers and a mob of followers, and its utility as an investment tool drops dramatically. High net worth individuals and institutional clients will always be able to afford quality active management, but retail investors could be left out in the cold. Ensuring the long-term viability of numerous and diverse active management options for the retail market is essential to protecting retail investors and their retirement savings.

The industry would be better served by focusing its energies on finding ways to convince Congress to revisit the ban on performance fees for registered investment companies. As Commissioner Peirce argued last fall, "allowing funds to experiment with performance fees may . . . facilitate the continued availability of actively managed funds." If active managers are forced out of the retail space because they cannot compete effectively on cost, retail investors will be the ones most harmed. Moreover, the restrictions on performance fee structures are already hurting retail investors for the reasons we have described above. Congress acting to allow advisers to charge some form of traditional performance fees would provide retail investors the flexibility to choose products that are responsive to their actual concerns, and will allow a critical industry to adjust to life in modern times.

Securities Offering Reform for Business Development Companies and Closed-End Investment Companies

In a welcome development, the SEC recently proposed rules that would modify the registration, communications and offering rules for BDCs and registered closed-end investment companies ("**CEFs**") to more closely align such processes with those that apply to operating companies. The SEC was obligated to propose rules in this area pursuant to The Small Business Credit Availability Act (the "**BDC Legislation**") and the Economic Growth, Regulatory Relief, and Consumer Protection Act (the "**CEF Legislation**"), passed by Congress in March and May 2018, respectively.

The proposed rules introduce five main reforms that would benefit BDCs and CEFs:

- **Registration Process**. The proposal would streamline the registration process to allow eligible BDCs and CEFs to use a short-form registration statement on Form N-2 to sell securities "off the shelf" more quickly and efficiently in response to market opportunities. A key benefit in this context is the ability to forward-incorporate information in future filings by reference.
- **Well-Known Seasoned Issuer Status**. The proposal would allow BDCs and CEFs with at least $700 million in public float to qualify as well-known seasoned issuers ("**WKSIs**") under the Securities Act of 1933 (the "**Securities Act**"). WKSIs enjoy automatic effectiveness of registration statements and amendments, among other benefits.
- **Final Prospectus Delivery Reforms**. The proposal would remove the requirement that BDCs and CEFs deliver a final prospectus with or prior to each sale when a final prospectus is already filed with the SEC.
- **Communications Reforms**. The proposal would allow BDCs and CEFs to rely on specific exemptions for communicating with investors without violating "gun-jumping" prohibitions, putting them on the same footing as operating companies.
- **Public Reporting Parity**. For funds that use a short-form registration statement, there is a proposed requirement to provide information regarding fees, expenses, premiums/discounts and outstanding senior securities in annual reports (which can be incorporated by reference into a previously filed registration statement). CEFs would be required to make Form 8-K filings for material developments under the Securities and Exchange Act of 1934 (the "**Exchange Act**"). Additionally, the proposal includes new Form 8-K requirements relating to material changes to investment objectives or policies and material write-downs of significant investments.

In this Alert, we summarize the above aspects of the proposal, and propose that the SEC should revise and clarify certain aspects of the proposal relating to the new public reporting requirements for BDCs and CEFs.

Registration Process

The proposal would provide BDCs and CEFs parity with operating companies by permitting eligible BDCs and CEFs to file a short-form registration statement on Form N-2 that will function like a "shelf" Form S-3 registration statement for operating companies. Short-form registration statements incorporate relevant information from periodic filings by the issuer and can be used for multiple future offerings of one or more types of securities. Once the SEC declares a shelf registration statement effective (or if it automatically becomes effective as for WKSIs) the issuer can use a prospectus to supplement the shelf for a specific offering. Such prospectus would include specific information about the offering that was omitted in the shelf. SEC review of the prospectus for a specific offering is not required, so once an issuer has an effective shelf registration statement it can quickly conduct an offering "off the shelf" without needing to navigate an SEC review process. Future periodic reports filed by the issuer are automatically incorporated by reference into the registration statement, so the issuer does not need to separately update the registration statement to include updated financial statements or other items already disclosed in its periodic reports prior to conducting an offering.

A BDC or CEF would be eligible to file a short-form registration statement if it meets the registrant requirements (*i.e.*, timely filed all reports and other materials required under the Exchange Act during the prior year) and transaction requirements (*i.e.*, at least $75 million of public float) of Form S-3. Registered CEFs also must be registered under the 1940 Act for at least one year immediately preceding the filing of the registration statement and have timely filed all reports required to be filed under Section 30 of the 1940 Act (*e.g.*, Forms N-PORT and N-CSR). We note that the public float requirement effectively excludes unlisted BDCs and CEFs, including interval funds and tender offer funds, from eligibility to file a short-form registration statement.

Improving the Proposal for Registration Requirements

The proposal's exclusion of unlisted CEFs and BDCs, while consistent with the treatment of operating companies, would perpetuate unnecessary updates for BDCs and CEFs that conduct continuous offerings pursuant to Rule 415 under the Securities Act and provide liquidity through periodic tender offers. Currently, these tender offer funds are not permitted to forward incorporate, which necessitates their updating their registration statements and undergoing SEC disclosure review at least annually in order to incorporate the fund's annual financial statements, even if no other material updates are being made. This process adds expenses to tender offer funds, but does not provide meaningful benefit to investors as the requirement to update the registration statement is triggered by incorporating financial statements that are already available to investors in the tender offer fund's annual report. The SEC should consider allowing tender offer funds (and interval funds) to use forward incorporation by reference to streamline the offering process for these products or, as an alternative, allow tender offer funds the ability to use Rule 486 (which is currently only available to interval funds) to make immaterial updates to their registration statement without requiring SEC disclosure review.

Well-Known Seasoned Issuer Status

In addition, the proposal would amend the WKSI definition under Rule 405 to include qualifying BDCs and CEFs, and BDCs and CEFs that qualify as WKSIs would be able to file an automatic shelf registration statement and register an unspecified amount of securities.

To qualify as a WKSI, a BDC or CEF must have at least $700 million in public float and be eligible to file a short-form registration statement, which means that the BDC or CEF must have: (i) been subject to the requirements of Exchange Act Sections 12 or 15(d) or 1940 Act Section 30 for at least one year and (ii) timely filed all reports required to be filed during the past year (other than certain current reports on Form 8-K). As with short-form registration statement eligibility, the public float requirement effectively excludes unlisted BDCs and CEFs, including interval funds, from eligibility to qualify as a WKSI. A BDC or CEF would also be ineligible to qualify as a WKSI if it (or a subsidiary) is the subject of a judicial or administrative decree or order arising out of a governmental action involving violations of the anti-fraud provisions of the federal securities laws.

Qualifying as a WKSI would come with a few key benefits. A WKSI can file a registration statement or amendment that becomes effective automatically, which would give the fund flexibility to take advantage of market windows, structure terms of securities on a real-time basis or change the plan of distribution in response to market conditions. A WKSI also can pay filing fees at any time in advance of a shelf takedown or pay at the time of each takedown.

Final Prospectus Delivery Reforms

Currently, BDCs and CEFs (or broker-dealers in a BDC or CEF offering) are required to deliver to each investor in a registered offering a statutory "final prospectus." BDCs and CEFs are not permitted to rely on the rules that allow issuers to satisfy the final prospectus delivery obligations when a final prospectus is or will be filed with the SEC within certain time frames.

Under the proposal, the prospectus delivery rules available to operating companies would be amended to remove the exclusion for BDCs and CEFs. As a result, BDCs and CEFs (or broker-dealers in a BDC or CEF offering) would no longer be required to deliver a final prospectus with or prior to each sale if the final prospectus is filed with the SEC and the securities are delivered with a notice to that effect.

Communications Reforms

The proposal would give BDCs and CEFs increased flexibility in their communications with investors and potential investors. Under the proposal, BDCs and CEFs would be eligible to rely on certain rules previously only available to operating companies, including:

- **Rule 134**, which permits issuers to publish factual information about the issuer or the offering, including "tombstone ads" (limited factual information about an offering);
- **Rule 168**, which permits issuers to publish or disseminate regularly released factual business information and forward-looking information at any time, including around the time of a registered offering;
- **Rule 164 and 433**, which permits the use of a "free writing prospectus" after a registration statement is filed—a written communication deemed to be an offer to sell a security that does not qualify as a statutory prospectus or preliminary prospectus (*e.g.*, term sheets); and
- **Rule 163**, which permits WKSIs to engage at any time in oral and written communications, including use of a free writing prospectus at any time (before or after a registration statement is filed).

The proposal would also amend the rules applicable to broker-dealer research reports to include a reference to registration statements filed on Form N-2 to expand coverage to BDCs and CEFs. Operating companies that file a registration statement on Form S-3 may rely on Rule 138, which permits a broker-dealer participating in a distribution to publish research about the issuer's other securities. For example, a broker-dealer participating in a distribution of an issuer's common stock could publish research about the issuer's fixed income securities pursuant to Rule 138. Although Rule 138 does not specifically exclude BDCs and CEFs from coverage, it does include references to Form S-3 but not Form N-2.

Public Reporting Parity

The proposal would amend certain rules and forms to tailor the disclosure and regulatory framework for BDCs and CEFs in light of the proposed amendments to the offering rules applicable to them.

Periodic Reporting Requirements

<u>Forward Incorporation</u>

A BDC or CEF filing a short-form registration statement on Form N-2 would forward incorporate all periodic reports into its registration statement. As a result, periodic reports would make up a substantial portion of a fund's registration statement. The proposal would require BDCs and CEFs using short-form registration statements to include in their annual reports: fee and expense tables; premiums and discounts; and outstanding senior securities.

<u>Annual Reports</u>

The proposal would also amend Form N-2 to require a registered CEF to include narrative disclosure about factors that materially affected the fund's performance during the most recently completed fiscal year (referred to as "management's discussion of fund performance," or "**MDFP**") in its annual report. This would apply to all CEFs, even those not using short-form registration statements. Although the SEC has required mutual funds and ETFs to include MDFP disclosure and BDCs (like operating companies) to include a narrative discussion of the financial statements of the company (referred to as "management discussion and analysis," or "**MD&A**"), Form N-2 does not include an MDFP or MD&A requirement for registered CEFs. The SEC believes that registered CEF investors would benefit from MDFP disclosure in a registered CEF's annual report because such disclosure would aid investors in assessing the fund's performance over the prior year (MDFP disclosure requirements are more appropriately tailored to the financial reporting of registered investment companies than MD&A requirements).

Further, the proposal would require BDCs to include their financial highlights in their registration statements and annual reports. Registered CEFs are required to include financial highlights in their registration statements and in annual reports; however, while BDCs include their full financial statements in their prospectuses, they are currently permitted to omit the financial highlights summarizing these financial statements (although many BDCs already include financial highlights in the footnotes to their financial statements). The SEC believes BDC investors would benefit from this disclosure given the importance of financial highlights information.

Lastly, the proposal would require BDCs and CEFs filing a short-form registration statement to disclose in their annual reports any outstanding SEC staff comments that remain unresolved and that the fund believes are material. This new requirement may create an issue for funds that are part of a larger complex, where a comment given to one fund arguably may apply to other funds. We believe the SEC should clarify in the adopting release (or the final rule) that the requirement only applies to comments directly received by a given fund.

Current Reporting Requirements

Form 8-K requires BDCs to disclose specific events and information on a current basis in the same manner as operating companies. In contrast, registered CEFs generally are not required to report information on Form 8-K, although some do so voluntarily. The proposal would require registered CEFs (even those that do not use short-form registration statements) to provide current disclosure on Form 8-K.

The proposal would also amend Form 8-K to add two new reporting items for BDCs and CEFs:

- **Item 10.01**: material changes to investment objectives or policies; and
- **Item 10.02**: material write-downs in fair value of significant investments (an investment would be considered significant if a BDC's or CEF's investment in a portfolio company exceeds 10% of its total assets).

Failure to file timely reports on Form 8-K under new Items 10.01 and 10.02 would not disqualify a BDC or CEF from eligibility to file a short-form registration statement.

Improving the Proposal's Current Reporting Requirements

Although we applaud the SEC's effort to improve current reporting of important information by BDCs and CEFs to investors and the market, we believe the requirement to disclose a material write-down in fair value of a significant investment should not be imposed on BDCs and CEFs. The SEC likens the requirement to an existing requirement in Form 8-K applicable to operating companies to report a material impairment to an asset (such as goodwill, accounts receivable or a long-term asset). Unlike operating companies, the purpose of BDCs and CEFs is to invest in securities, which inherently change in value. While a material change in a balance sheet asset of an operating company may be an unusual event, a material change in the value of a security is not an unusual event.

> *"... we believe the requirement to disclose a material write-down in fair value of a significant investment should not be imposed on BDCs and CEFs."*

While the SEC's proposal would only apply to significant assets (*i.e.*, those that make up at least 10% of the BDC's or CEF's total assets), a requirement to disclose a material change in only one asset does not seem consistent with what is relevant to an investor. Ultimately investors are affected by a change in the overall net asset value (**"NAV"**) per share of a BDC or CEF. Information about the value of a single asset is not as useful to an investor as stating the NAV per share of a BDC or CEF.

Additionally, as a practical matter, BDCs and CEFs value their securities when they strike their NAV. Some BDCs and CEFs only strike NAV monthly or quarterly. These BDCs and CEFs would not typically assess the value of a significant asset outside of their typical NAV valuation process. Therefore, the BDC or CEF would confirm the amount of the material write-down of a significant asset simultaneously with confirming the BDC's or CEF's overall NAV. Because the overall NAV is the more important measure to an investor and will be available at the same time, the requirement to report a material write-down of an individual asset (even a significant asset) does not meaningfully assist investors.

Novel Co-Investment Application Filed—A New Approach to Resolving an Old Problem

Investors, investment advisers, and the SEC alike are all focused on increasing retail access to investment strategies historically limited to wealthy individuals and institutional investors. Allowing registered funds to co-invest alongside private funds is a key prerequisite to products that allows retail investors access to such investment strategies, but a registered fund's ability to co-invest is restricted by the 1940 Act. For co-investment opportunities that involve negotiation of terms other than price ("**Negotiated Co-Investments**"), the SEC historically has required that funds and their advisers apply for an exemptive order and agree to more than a dozen conditions that restrict how the funds and advisers behave with respect to identifying, entering into, allocating and approving Negotiated Co-Investments. These conditions, along with pages and pages of narrative description about how the adviser and funds will operate, form what becomes each set of applicants' application for what we will refer to as "standard relief."

We have argued in previous Alerts that the system for obtaining standard relief is outdated and in desperate need of a ground-up overhaul. A recent co-investment application filed by FS Global Credit Opportunities Fund, et al. (the "**FS Application**"), if granted by the SEC in a form similar to the application (which has been amended once as of the date of this Alert's publication), would go a long way towards reforming the most significant issues with the standard relief. In particular, the FS Application envisions a broad, principles-based approach to co-investment relief rather than a detailed and customized application unique to the applicant's business. We believe this would be a tremendous step forward, and encourage the SEC and its staff to consider the FS Application seriously. However, the FS Application leaves certain issues unaddressed. In this Alert, we take a look at how the FS Application would change the status quo conceptually, what benefits it provides practically, and finally offer our thoughts on certain elements that we think are missing from the application but are necessary for it to provide a comprehensive solution.

The Old Problem and the New Approach

Applications for standard relief require an unnecessary amount of detail, which has led to a situation where innovation has been plodding, unpredictable and uneven. What works for one adviser and one strategy may not work for another adviser or another strategy. Under the standard relief, the detailed descriptions, representations and conditions required from each set of applicants mean that if an applicant wants to innovate in a material way, their application needs to be different from precedent. As each adviser approaches the application process with a slightly different desired outcome in mind, these deviations happen frequently. While the SEC will occasionally accept a significant customization proposed by an applicant, those major requests (and even relatively minor requests) are often rejected. Even when changes are accepted, they usually add considerable time to the SEC's review process, resulting in a timeline that is inconsistent with the capital formation timing goals of the applicant. As a result, an exemptive relief process that was initially designed to encourage innovation arguably is now having the opposite effect.

Investment advisers preparing to launch new products effectively have a choice between filing an application for standard relief that is in every material respect in line with what previous applicants have successfully requested—a process which still takes months to complete—or they can submit an application that modifies precedent to reflect their intended strategy and contend with the possibility that the SEC may reject their application months or even years after it was initially filed. Far too often, the result is simply that advisers will give up on fledgling products that involve co-investments between retail funds and private funds once they understand that they will need to obtain bespoke exemptive relief from the SEC to innovate in this particular space.

We believe that the SEC can more than adequately protect investors while promoting innovation that brings retail investors into private/institutional strategies by ending the historical dependence on lengthy, detailed descriptions and representations in co-investment applications that detail how each applicant fund complex and its advisers will operate. The staff of the SEC's Division of Investment Management recommended in 1992 that SEC rules be amended to permit certain joint transactions in which a registered fund may participate on the same terms as its affiliates. In place of a revised rule, we believe a new baseline application that is similar to the FS Application will better match the spirit of the 1992 recommendation and allow advisers to innovate much more freely than under the standard relief.

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The FS Application asks the SEC to grant exemptive relief that would allow registered funds to engage in Negotiated Co-Investments based on "fair and equitable principles" rather than requiring the registered fund's board to review and approve co-investments. In other words, the application rests on principles that dictate what is and is not permitted, rather than relying on specific representations about what exactly the fund complex and adviser will do to comply with those principles. The conditions in the FS Application, which are considerably fewer in number than those in the standard relief, have been reworked almost entirely to reflect this broader and more principles-based approach. These changes should make compliance with co-investment orders more easily administrable. They also have the additional effect of furthering the SEC Staff's laudable goal of lessening unnecessary administrative burdens on fund boards.

Significant Practical Benefits of the FS Application

The FS Application streamlines the current approach to co-investment relief with its principles-based conditions and focus on an adviser's fiduciary duties. We highlight certain of the significant practical benefits of this change below.

Lack of Detailed Representations Regarding Co-Investment Program

Unlike standard relief, the FS Application does not have a section in the body of the application describing the mechanics of the co-investment program and the allocation principles. The FS Application lacks a description of allocation methodology, described in standard relief as "available capital" or "order size," which have historically been used as a framework to allocate participation in Negotiated Co-Investments between registered funds and affiliated funds. Instead, the FS Application requires only that an investment adviser develop policies to allocate Negotiated Co-Investments "fairly and equitably" among participating funds, which is a standard equivalent to an adviser's existing obligations under the Advisers Act and the 1940 Act.

The sections outlining mechanics and allocation methodology, which typically range from five to ten pages, make up a substantial portion of most applications for standard relief and contain material representations that the SEC often includes when it publishes a notice of its intent to grant an application for exemptive relief. The streamlined nature of the FS Application, if approved by the Staff and the SEC, will likely lead to a more generic, "one-size-fits-all" order than the current particularized orders associated with the standard relief. This will not only have the effect of a more efficient process for seeking relief, but will also allow evolution of a firm's co-investment program over time to rest on more basic fiduciary principals, rather than compliance with potentially outdated representations.

Sharing Co-Investment Opportunities

The FS Application does not include a requirement to compel sharing of Negotiated Co-Investments among affiliated funds. Under standard relief, if an investment adviser considers an Negotiated Co-Investment opportunity for a private fund that is part of the co-investment program, it must also consider that same opportunity for every registered fund (under older exemptive orders) or every registered fund for which the opportunity satisfies certain "board-established criteria" (a feature of more recent orders). This requirement was designed to ensure that registered funds could not be excluded from any "good deals," and that registered funds are not only brought in to co-invest on "bad deals." Rather, the registered funds and private funds are forced by this condition to have equal access to an adviser's entire pipeline of opportunities.

The FS Application does not require that an adviser will offer its registered funds access to all of the Negotiated Co-Investments (or all of such opportunities that fall within the board-established criteria) it considers for the affiliated funds; instead, the FS Application only requires (i) that an adviser implement policies to ensure that opportunities to participate in Negotiated Co-Investments are allocated in a manner that is fair and equitable to every registered fund and (ii) that the adviser negotiating the transaction considers the interests of any participating registered fund. Thus, the FS Application relies on the adviser's pre-existing fiduciary duties to manage conflicts and allocation determinations. This avoids the need to offer, consider and report opportunities that are not appropriate for a registered fund but nonetheless may have been captured by the expansive language that is present in standard relief.

Role of the Regulated Fund Board

The conditions of the FS Application also require considerably fewer specific board actions and overall involvement in Negotiated Co-Investments than under the standard relief, consistent with the approach we recommended in our [October 2018 Alert and recent SEC initiatives]. The standard relief requires prior approval of every Negotiated Co-Investment by the boards of each registered fund participating in the transaction. The FS Application, on the other hand, contemplates that a participating registered fund's board would not be required to approve most Negotiated Co-Investments. The FS Application provides instead that registered funds may participate in Negotiated Co-Investments so long as the registered fund's board has (i) reviewed the co-investment policies of the participants in the investment and determine that the registered fund would not be disadvantaged and (ii) approve the adviser's policies and procedures, which must be designed to ensure compliance with the requested order.

In addition to a notable reduction in deal-by-deal information presented to the boards of registered funds, other reporting obligations are also curtailed in the FS Application. Under the standard relief, a summary review of all Negotiated Co-Investments considered for the registered fund is required to be presented to the board quarterly. Instead of receiving specifics about all co-investment transactions offered to the registered fund (both those it passed on and those it participated in) on a quarterly basis, as is the case under the standard relief, the FS Application contemplates that each registered fund's board would receive an annual report of the registered fund's participation in Negotiated Co-Investments from the fund's chief compliance officer along with information regarding any material changes to how affiliated funds and advisers have decided what opportunities to allocate to the registered fund.

Proprietary Accounts

The FS application changes the limitations on who may participate in a Negotiated Co-Investment so that advisers and control affiliates of advisers acting in a principal capacity may participate. Under the standard relief, proprietary accounts are only permitted to participate in Negotiated Co-Investments on an overflow basis—meaning that they can only buy portions of an opportunity that client funds do not want. The FS Application contemplates that the same general principles governing allocations between client funds would also apply to allocations involving proprietary accounts. This change essentially allows proprietary accounts to have *pari passu* allocations with registered funds and other client accounts. So long as the allocation determination is performed in a manner that is fair and equitable to participating registered funds, the FS Application does not place any further limitations on the involvement of proprietary accounts. This change avoids the need for an adviser to make unnecessary determinations regarding what constitutes overflow, and will permit firms with capital markets affiliates to provide registered funds with access to investment opportunities that might otherwise not have been available given the practical way in which firms compete for opportunities to originate loans.

Inclusion of BDC Joint Ventures

The FS application specifically contemplates that joint ventures formed by BDCs may participate in Negotiated Co-Investments. Under the standard relief, it is not clear that joint ventures may participate in Negotiated Co-Investments because they are neither registered funds, wholly owned subsidiaries of registered funds, private funds advised by the adviser or proprietary accounts, which are the only categories of participants that may explicitly join a Negotiated Co-Investment. The FS Application removes that ambiguity by explicitly defining joint ventures as permissible participants to Negotiated Co-Investments made under the exemptive relief. This should have a positive effect for fund returns, since it would increase the access of joint venture subsidiaries to the high-quality loans in which a sponsor has the highest conviction (and thus desires to place into several accounts at once).

Follow-Ons Treated as Co-Investments

The FS Application does not draw a distinction between follow-on investments and any other type of Negotiated Co-Investments, which eliminates many of the restrictions currently associated with follow-on investments under the standard relief. Currently, if the proposed participants to a Negotiated Co-Investment have any pre-existing investments in the issuer, another Negotiated Co-Investment in that same issuer is only permitted if the pre-existing investments were either:

(i) obtained pursuant to the standard relief or

(ii) (a) acquired prior to the fund complex relying on the standard relief, (b) in a transaction in which the only term negotiated was price, and (c) acquired either (1) in reliance on MassMutual[8] or (2) in a transaction occurring at least 90 days apart and without coordination between the funds.

Moreover, and perhaps more problematically, it is not possible for a fund to participate in a follow-on transaction if it was not involved in the original Negotiated Co-Investment. This effectively prevents newly established funds from participating in follow-on transactions alongside older funds. These restrictions are largely eliminated under the FS Application, and instead the board of participating registered funds must determine that the transaction is in the best interest of the registered funds and that it would not involve overreaching by the registered fund. This change will benefit firms that have launched new funds since an initial investment.

Pre-Existing Investments

The FS Application eliminates the outright prohibition on Negotiated Co-Investments in issuers in which an affiliated fund holds a pre-existing investment. Under the standard relief, Negotiated Co-Investments in an issuer in which an affiliate currently holds a position are not permitted (unless such investment is considered a follow-on investment, discussed above).

8. Transactions referred to as "MassMutual" transactions are those where all of the affiliated parties participate on the same terms and there are no terms negotiated other than price, a reference to the seminal no-action letter on this topic.

Instead of prohibiting Negotiated Co-Investments in issuers in which an affiliate holds a position, the FS Application contemplates that such Negotiated Co-Investments may proceed if the boards of any participating registered funds determine that the transaction is in the best interest of their respective registered fund and that it would not involve overreaching. This practical innovation will allow large, multi-strategy firms to manage different strategies more effectively, without need to worry about unrelated and immaterial investments in the issuer by other funds pursuing different strategies.

Unresolved Issues in the FS Application

While the FS Application is a very positive step toward a principles-based approach to co-investing for registered funds, it leaves a few key issues unaddressed.

Multiple Classes of Securities

As drafted, the FS application would retain the standard relief condition that Negotiated Co-Investments only involve the same class of securities for all participants, to be acquired at the same time, for the same price and with the same conversion, financial reporting and registration rights, and with substantially the same other terms (provided that settlement dates may differ up to ten business days, consistent with current orders). This general condition is designed to ensure that co-investing funds have the same incentives and that their interests are aligned. While that is in keeping with the spirit of the SEC's prior statements on the issue, the inclusion of a specific requirement that all of the participants invest in the same class of security remains potentially problematic.

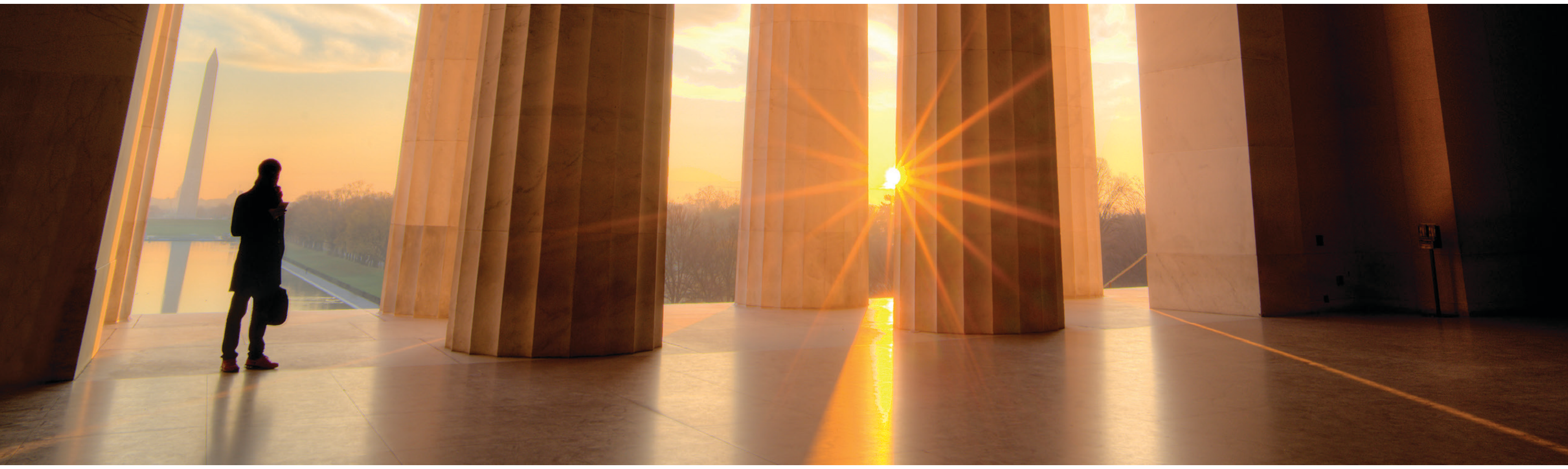
In many Negotiated Co-Investments, the participants are investing in multiple tranches of debt, a subset of which may not be a permitted investment for certain funds. For example, a Negotiated Co-Investment involving a term loan may also involve a revolving loan facility or an equity kicker. Six funds may want to co-invest in the term loan, but perhaps only five of those six want to acquire the revolver or equity kicker because the sixth fund's strategy prevents it from acquiring revolvers or because the fund is potentially restricted from acquiring equity securities. Or the sixth fund may be a regulated fund that does not want a revolver due to the unfunded nature of the commitment or an equity kicker due to the target level of current income it seeks to achieve. Under both the standard relief and the FS Application, if the sixth fund participates but does not take the revolver or equity kicker, none of the other five funds can acquire the revolver or equity kicker (which likely would result in a borrower going with different lenders, as revolvers and, to a lesser degree, equity kickers, are a key part of many financing arrangements). Alternatively, the registered fund could be excluded from the transaction entirely, and the other five funds could invest pursuant to the limitations of their organizational documents without issue. None of these outcome serves any true investor protection rationale, and we believe a new default template should address this type of scenario more gracefully than an outright ban. We believe a narrow exception for revolvers or equity kickers would be appropriate, or a broader exception with greater board oversight.

Equity Investments

In some cases, often without intent (*i.e.*, because of restructurings), a fund (together with its affiliates) may become the holder of greater than 5% of the equity of a borrower, and the issuer might then be considered an affiliate of the fund. Transactions with affiliates are restricted by the 1940 Act. A subsequent follow-on investment would be permitted if an issuer were an affiliate of only registered funds (under Rule 17a-6), but the participation of private funds in the Negotiated Co-Investment would potentially prohibit the follow-on investment as there is otherwise no applicable 1940 Act exemption. We believe any new form of co-investment relief should address these affiliation concerns for equity investments so that investments in equity and debt are treated in the same manner, or the SEC Staff should separately confirm that Rule 17a-6 may be applied to situations where a portfolio company is an affiliate of both registered funds and private funds that are affiliated with the registered fund.

Next Steps

As of the date of this alert, no one else has filed an application that follows the template laid out by the FS Application. But if the form of the application does not address other outstanding issues that advisers have with the proposed relief in the FS Application, it is entirely possible that other applicants may consider filing a modified form of the FS Application to address their concerns directly with the SEC Staff. If that were to happen, it may slow the SEC's review process considerably. The changes contemplated by the FS Application also could require a formal SEC vote for approval, which would add additional time to the process, although it is also possible that the Staff believes it has adequate delegated authority in the co-investment space to approve an order itself. If the FS Application is granted, we expect a substantial number of applicants will seek the same relief immediately thereafter. In the meantime, however, investment advisers that need to obtain co-investment relief on a predictable timeline would be best served by seeking the standard relief, since novel exemptive relief in this area has in the past taken years to resolve. The SEC's mission includes a mandate to protect investors and a mandate to facilitate capital formation. We believe this form of relief would be a catalyst for capital formation without sacrificing investor protection, and we strongly urge the SEC to move forward quickly on this form of relief. formation without sacrificing investor protection, and we strongly urge the SEC to move forward quickly on this form of relief.



M&A Transactions

Acquiror	Acquired or Target Company	Type of Transaction and Status
Atria Wealth Solutions, a wealth management solutions holding company that serves financial advisors and institutions and has more than $50 billion in assets under administration	**NEXT Financial Group, Inc.**, an independent broker-dealer that serves financial advisors and their clients and has approximately $13 billion in assets under administration	Acquisition (terms not disclosed)
Beacon Investment Advisory Solutions Services, Inc., a wealth management firm with approximately $2.2 billion in assets under administration	**Tirschwell & Loewy, Inc.**, an independent RIA with approximately $750 million in AUM	Acquisition (terms not disclosed)
Blackstone Alternative Asset Management ("BAAM") Strategic Capital Group affiliated funds, BAAM is an alternative asset management and financial services firm with approximately $78 billion in AUM	**GI Partners**, a private middle-market alternative asset manager that has raised more than $17 billion in capital from institutional investors	Acquisition of minority interest (terms not disclosed)
Brookfield Asset Management Inc., an asset manager with more than $350 billion in AUM	**Oaktree Capital Group, LLC**, an investment manager with $120 billion in AUM as of December 31, 2018	Acquisition through purchase of all outstanding Class A units for either $49.00 cash or 1.0770 Class A shares of Brookfield per unit, at the option of the Oaktree Class A unitholders, for a premium of 12.4% per unit based on the closing price of Brookfield shares and Oaktree units on March 12, 2019. Unitholders of Oaktree Capital Group Holdings, L.P. ("OCGH"), which holds all of Oaktree's Class B units, will sell 20% of their units to Brookfield for the same consideration as the Class A holders. Upon consummation Brookfield will hold approximately 62% of the outstanding units of Oaktree and, pursuant to the liquidity schedule, Brookfield could own 100% of Oaktree as early as 2029. The transaction also provides for a $225 million termination fee under certain special circumstances.
Calamos Investments, a global investment management firm headquartered in Chicago with approximately $20 billion in AUM	**Timpani Capital Management LLC**, a boutique investment manager focused on small- and mid-cap growth investing and with more than $300 million in AUM	Acquisition (terms not disclosed)
Carillon Tower Advisors, Inc., an asset-management firm that serves institutional clients and had $64.6 billion in assets under management and advisement as of January 31, 2019	**ClariVest Asset Management LLC**, an asset-management company and hedge fund sponsor that has $7.3 billion in assets under management and advisement as of January 31, 2019	Acquisition through affiliate that will increase its existing 45% stake to 100% (terms not disclosed)

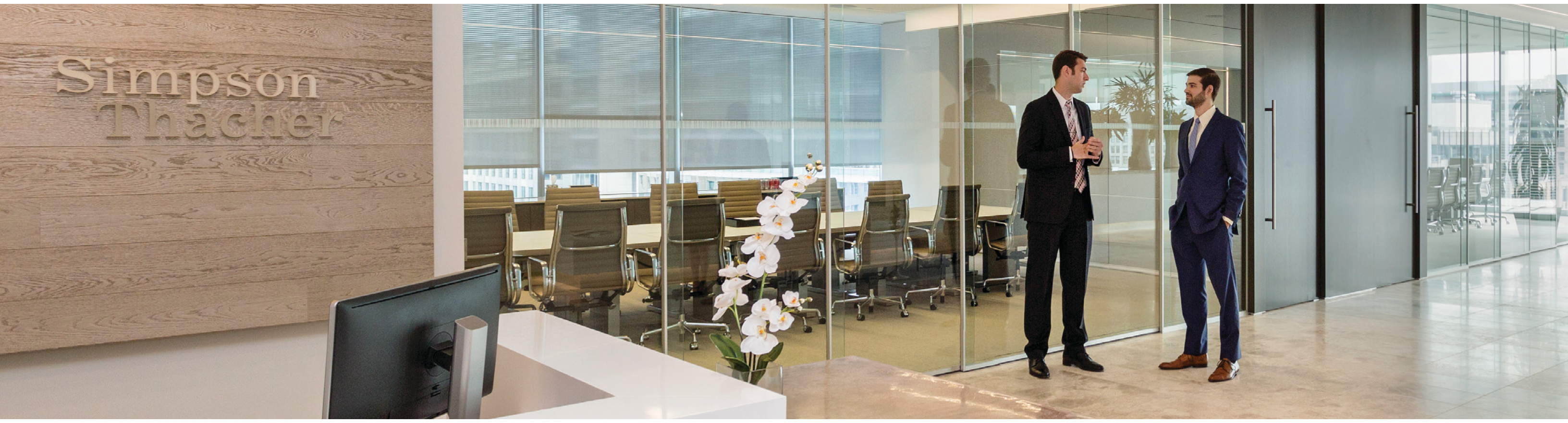
M&A Transactions *(continued)*

Acquiror	Acquired or Target Company	Type of Transaction and Status
Citizens Financial Group, a bank with $158.6 billion in assets as of September 30, 2018	**Clarfeld Financial Advisors, LLC**, a wealth management and financial advisory firm specializing in HNW and UHNW clients and having approximately $6.6 billion in AUM and $900 million in assets under administration	Acquisition (terms not disclosed)
Goldman Sachs Asset Management, an asset manager with more than $200 billion in assets under management as of September 30, 2018	**Aptitude Investment Management**, an investment firm specializing in hedge fund services for large institutions that manages approximately $3.5 billion in discretionary assets	Acquisition (terms not disclosed)
Kudu Investment Management, LLC, a registered investment adviser that specializes in minority equity investments	**Versus Capital Advisors, LLC**, a real assets investment manager that manages approximately $4 billion for investors	Acquisition of minority interest (terms not disclosed)
Medalist Partners, LP, an alternative investment manager with approximately $2.25 billion in AUM	**JPM Credit Advisors**, an investment manager with expertise in managing CLOs	Acquisition of majority interest (terms not disclosed)
Mercer Global Advisors Inc., a RIA with approximately $15 billion in AUM	**Arbor Asset Management, LLC**, a wealth management firm with $350 million in AUM	Acquisition (terms not disclosed)
Resolute Investment Managers, Inc., ("Resolute") a multi-affiliate asset management platform with $71.2 billion in AUM as of September 30, 2018	**SSI Investment Management**, an institutional investment manager that specializes in risk-mitigation strategies for institutional and HNW investors and had $1.9 billion in AUM as of September 30, 2018	Acquisition of a majority interest (terms not disclosed)
Shelton Capital Management, an asset manager with more than $1.85 billion in assets under management as of December 31, 2018	**Cedar Ridge Partners, LLC**, a private RIA offering alternative investment products	Acquisition (terms not disclosed)
The Mather Group, a fee-only wealth management firm that has more than $7 billion in assets under advisement	**Astraeus Advisers**, a multifamily office with more than $1 billion in AUM	Acquisition (terms not disclosed)

1st Quarter 2019
Closed-End Fund Public Offerings

PIMCO Energy and Tactical Credit Opportunities Fund

Structure:	Non-diversified, limited term, closed-end management company
Investment Objectives/Policies:	The Fund's primary investment objective is to seek total return, with a secondary objective to seek to provide high current income. The Fund seeks to achieve its investment objectives by focusing on investments linked to the energy sector and investments linked to the credit sectors. The Fund seeks to achieve its investment objectives by utilizing a flexible multi-sector approach to investing across various asset classes. Top-down and bottom-up strategies are used to identify multiple sources of value to seek to generate returns. With PIMCO's macroeconomic analysis as the basis for top-down investment decisions, the Fund seeks to offer investors an actively-managed portfolio that aims to capitalize on what PIMCO believes are attractive opportunities across markets and the capital structure. In selecting investments for the Fund, PIMCO expects to develop an outlook for the energy and credit sectors and the overall economy, perform fundamental analysis of the credit markets and the underlying businesses owned and operated by energy companies and use other investment selection techniques. In order to maintain flexibility and to have the ability to invest in opportunities as they arise, it is not an objective of the Fund to focus its investment in any specific geographic sector (although it may, but is not obliged to, in practice). The proportion of the Fund's assets committed to investments with particular characteristics (such as type of energy product, debt instrument, entity structure or geography) is expected to vary based on PIMCO's outlook for the economy as a whole, the energy sector, and the credit markets. Similarly, although the Fund has the capability to use the types of investments outlined in this policy, it is possible that the Fund will not invest in certain instrument types all of the time or at all. While these analyses are performed daily, material shifts in investment exposures typically take place over longer periods of time.
Manager:	Pacific Investment Management Company, LLC
Distributor:	American Stock Transfer & Trust Company, LLC



Simpson Thacher's dynamic, long-standing Registered Funds Practice encompasses all aspects of the investment management business. Our practice focuses on alternative asset managers seeking to access retail investor channels, asset management mergers and acquisitions, and advising on cutting-edge regulatory policy and strategy matters.

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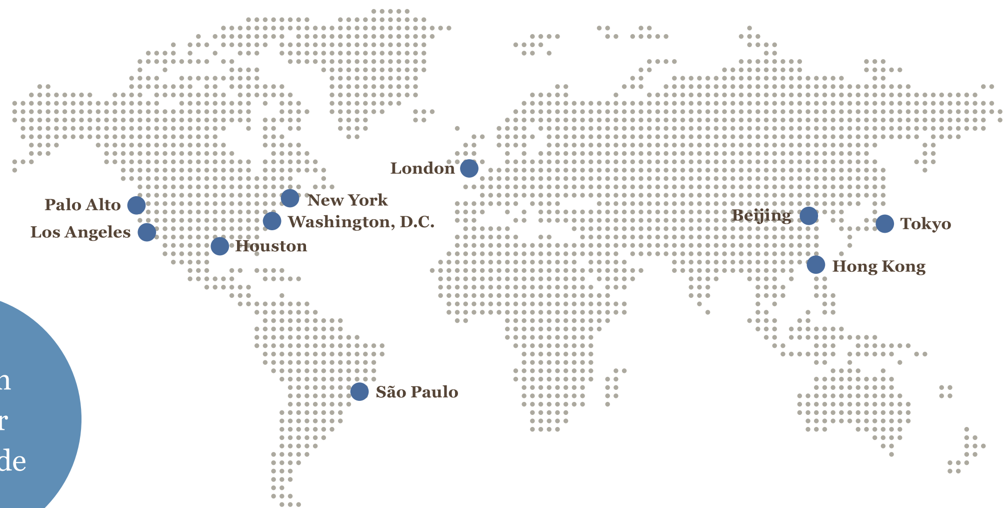

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