# Registered Funds Alert

October 2018

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The latest edition of Simpson Thacher's Registered Funds Alert discusses recent developments in the registered funds industry, including: an examination of co-investment relief history and suggestions moving towards broader relief; a summary of themes of primary concern regarding standards of conduct for advisers and broker-dealers; a discussion of recent statements and actions emphasizing SEC staff guidance limitations; and Simpson's predictions and suggestions regarding the SEC's derivatives rule re-proposal.

# The Evolution of Co-Investment Exemptive Orders and Why They Should Become Extinct

A key issue facing our clients, and the asset management industry generally, is developing ways for retail investors to access investment strategies typically reserved for institutional and other wealthy investors. Based on recent remarks by SEC Chair Jay Clayton and related media reports, the SEC plans to issue a concept release seeking public comment on ways to increase the ability of retail investors to invest in private companies. Allowing registered funds (i.e., an investment company or business development company ("**BDC**")) to co-invest with affiliated funds is a critical first step toward accomplishing these goals. Unfortunately, co-investing is prohibited for registered funds except in certain limited circumstances, either by relying on narrow no-action letters or going through an expensive and time-consuming exemptive application process that still restricts such co-investment dramatically.

In this Alert, we provide background on the ability of registered funds to co-invest with affiliated funds and describe the evolution of co-investment exemptive orders that have been granted by the SEC. We then propose that the SEC should revise its historical approach and take steps to allow registered funds to engage in a broader range of co-investments without requiring specific exemptive relief.

## Overview and Background

One of the major problems that the Investment Company Act of 1940 (the "**1940 Act**"), sought to address and regulate was the ability of investment advisers and other affiliates to take advantage of investment funds through affiliated transactions (either with the affiliate on the same side of the negotiating table as the fund or as an opposing counterparty). In this Alert, we focus on transactions where a fund and its affiliate(s) are on the same side of the negotiating table, typically referred to as a joint transaction or co-investment. Sections 17(d) and 57(a)(4), and Rule 17d-1 under the 1940 Act (collectively, the "**Joint Transaction Regulations**") set forth the restrictions governing joint transactions among registered funds implemented to protect investors from the potential harms associated with self-dealing and overreaching by advisers and other affiliates.

Over time, it has become clear that there are transactions that are technically prohibited by the Joint Transaction Regulations, but do not present the dangers of self-dealing and overreaching that animate the Joint Transaction Regulations. For decades, the SEC and the staff of the SEC's Division of Investment Management (the "**Staff**") have taken the position that a registered fund should be permitted to engage in certain limited types of co-investment transactions with its affiliates without violating the Joint Transaction Regulations. Since it was first adopted in 1957, Rule 17d-1 has explicitly contemplated exemptive orders that would permit co-investments that would otherwise be prohibited by the Joint Transaction Regulations. In 1992, after reviewing the efficacy of existing regulation, the Staff went so far as to recommended that Rule 17d-1 be amended to permit certain joint transactions where the registered fund participates on the same terms as its affiliates.[1] Resource constraints and other higher priority rulemaking initiatives have prevented such an amendment to Rule 17d-1 from materializing and will likely continue to do so for the foreseeable future, but the Staff has taken no-action positions and issued exemptive orders to lessen the restrictiveness of the Joint Transaction Regulations, consistent with the recommendations it gave in the 1992 Report.

Under the relevant line of no-action letters, a registered fund is permitted to co-invest alongside an affiliated entity in transactions where all of the affiliated parties participate on the same terms and there are no terms negotiated other than price ("**Non-Negotiated Co-Investments**") and allocations of opportunities are made fairly and pursuant to board-approved policies.[2] Essentially, the Staff's position has been that because there are no negotiations through which affiliates could manipulate the terms of a Non-Negotiated

1. SEC Division of Investment Management, Protecting Investors: A Half Century of Investment Company Regulation (May 1992) (the "1992 Report").

2. Such transactions are commonly referred to as "Mass Mutual" transactions, a reference to the seminal no-action letter on this topic.

Co-Investment and potentially place a registered fund at a disadvantage relative to another client, a Non-Negotiated Co-Investment does not pose the risks that the prohibitions in the Joint Transaction Regulations are designed to address.

For joint investment opportunities that involve negotiation of terms other than price ("**Negotiated Co-Investments**"), the SEC has required registered funds to request specific relief through the exemptive order process. To obtain such relief, the SEC has historically required applicant funds and their advisers 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 form the guide rails of what becomes each set of applicants' "Co-Investment Program."

While some aspects of co-investment exemptive applications have evolved over time, there are several elements of each Co-Investment Program that are generally consistent across the board. One key condition that is universally included in co-investment exemptive applications is that all participating affiliates must invest on the same terms and (more or less) at the same time. This condition mitigates the overreaching concern that a registered fund could be disadvantaged relative to its affiliates with respect to a specific transaction.

Another key condition is that Negotiated Co-Investments considered for any affiliated fund in the Co-Investment Program must also be considered for a registered fund. That is to say, if the adviser is considering a Negotiated Co-Investment opportunity for any affiliated private fund or one specific registered fund in the Program, it must also consider whether the opportunity would be appropriate for all other registered funds in the Program. From the view of the SEC, this condition exists to ensure that registered funds are not only brought in to participate on less lucrative deals, or to absorb overflow, but instead have full access to any deals available to the other funds participating in the Co-Investment Program.

In addition to governing the initial Negotiated Co-Investments, all Co-Investment Programs also govern the process by which dispositions and follow-on opportunities must be shared and the process by which those decisions must be made. Many Co-Investment Programs allow for dispositions and follow-on transactions to be conducted under the umbrella of the Co-Investment Program (i.e. to permit Program participants to jointly negotiate the terms of a follow-on investment or a disposition with respect to terms other than price) only if the initial investments were also made under the terms of the Co-Investment Program.

Once all relevant funds have had the opportunity to determine whether to participate in a Negotiated Co-Investment opportunity, and the participating affiliated entities have made their determinations as to their desired participation levels (as determined by the adviser to each participating entity), the opportunity is allocated accordingly. If the demand for the opportunity from participants exceeds what is available to the manager as a whole, the investment opportunity is allocated among all of the co-investing entities on a pro rata basis, based on criteria specific to each Co-Investment Program. The boards of each participating registered fund, including a majority of its independent directors, must approve of the transaction before the registered fund may participate.

## Evolving Co-Investment Programs

For many years, Co-Investment Programs all followed a similar template, but certain variations in exemptive orders have evolved rapidly over the past few years. This evolution is primarily driven by the fact that asset managers are increasingly large and complex organizations, the one-size-fits-all presumptions of the standard relief have proven to be unworkable for numerous firms. For large asset managers who often have multiple advisers with a variety of registered funds and private funds, the conditions imposed under the standard form of exemptive relief require onerous amounts of information to be shared between affiliates and a substantial compliance framework to manage all of the regulatory obligations.

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The wave of new innovation in Co-Investment Programs began with an order granted to Apollo Investment Corporation and its affiliates ("**Apollo**") in 2016. After years of negotiation with the Staff, Apollo was successful in seeking a more scalable and flexible approach than had been historically granted, and better reflects the challenges facing certain types of larger asset managers.

One notable modification that arose out of Apollo's relief was to add a mechanism that allows the board of a registered fund to set criteria that would limit the range of transactions that must be presented to that registered fund. As fund investment strategies are often broadly worded, this development allows an adviser to focus on opportunities that are the most likely to be appropriate for a registered fund and can significantly reduce the administrative burden on the adviser of documenting why a registered fund declined to participate in opportunities that are unlikely to fit its core strategy or target risk/return profile. The line of applications that have adopted this mechanism refer to this concept as "Board-Established Criteria."

Apollo's order also added the flexibility to allow disposition and follow-on transactions with respect to initial investments that were not made under the Co-Investment Program to be completed under the Co-Investment Program so long as certain conditions and board approvals are met and obtained. The newer applications that include this flexibility refer to these as "enhanced-review" dispositions and follow-ons.

Ultimately, however, Apollo's application was tailored to reflect how Apollo's business is structured, which does not necessarily reflect other potential applicants. The SEC has issued at least 45 co-investment exemptive orders since Apollo's was granted in 2016. As the SEC and the industry have grappled with this reality, it has resulted in a patchwork of exemptive applications with varying representations, conditions and requirements as each applicant attempts to find a solution that works for its business model.

For example, there has been a divergence in exemptive applications since Apollo's relief was granted regarding how investment allocations are made when an opportunity is oversubscribed. Prior to Apollo's exemptive order, applications stated that in such circumstances allocations would be made pro rata on the basis of available capital (i.e., that the funds with the most cash on hand would get the largest allocation). Advisers found that the strict available capital requirement could lead to undesirable results. Apollo's application took a different approach, instead basing allocations for over-subscribed investments on the relative size of "internal orders," essentially reflecting the actual demand expressed by each affiliated fund. In more recent applications using this "internal order" approach, however, the SEC has begun to add additional requirements around the internal order process in an attempt to ensure that registered funds are not disadvantaged—even going so far as to require legal or compliance personnel to attend allocation committee meetings and take minutes.

Other recent applications have eschewed the internal order model and instead modified the definition of "available capital" to be a more nuanced concept that involves some discretion on the part of the adviser and variables, such as liquidity considerations, existing commitments and reserves, if any, the targeted leverage level, targeted asset mix, risk-return and target-return profile, tax implications, etc. It is unclear at this point how much of a difference exists between the "internal order" and the "modified available capital" approaches.

## The Problem with Co-Investment Exemptive Relief

The growing patchwork of co-investment exemptive orders is a consequence of the SEC granting exemptive relief for individual Co-Investment Programs rather than taking a principles-based approach of blessing a wider variety of Negotiated Co-Investments.

It takes an enormous amount of time for the SEC Staff to review and understand the internal interplay of increasingly large and complex asset managers, which takes valuable SEC resources away from other important areas of focus. Similarly, while the benefit of co-investment relief is that registered funds are allowed to participate in Negotiated Co-Investments from which they would otherwise be excluded, the complexity and restrictions of the applications and related conditions can discourage an asset manager from seeking the benefit of relief for its registered funds. Absent a co-investment order, registered funds are left out of Negotiated Co-Investments altogether.

While the SEC's goal of protecting registered funds and their shareholders are well intentioned, the exclusion of registered funds from Negotiated Co-Investments is ultimately to the detriment of retail investors. Co-investments generally provide registered funds a host of benefits, including an increase in deal flow, the opportunity to participate in larger financing commitments and enhanced selectivity, and more favorable deal terms. All of these benefits have been recognized in the context of Non-Negotiated Co-Investments through no-action relief and in the context of Negotiated Co-Investments through exemptive orders, but there persist, in our view, unnecessary limitations on registered funds' access to attractive co-investment opportunities.

## The Path Forward

While the SEC's willingness to grant the Apollo-style relief was a welcome departure from the historical one-size-fits-all relief, it has ultimately led the SEC down a path where the Staff must review complex and detailed exemptive applications that require a significant amount of customization for each individual applicant. The resulting patchwork of exemptive orders with sometimes meaningful variation in representations and conditions creates regulatory uncertainty and potentially competitive advantages (or disadvantages) for some asset management firms. As the SEC has recognized in the ETF context, variations in the regulatory structure that result from a complex web of exemptive orders can pose a problem and are ripe for simplification. Our view is that the SEC would be best served by exiting the business of granting exemptive orders for basic forms of Co-Investment Programs.

As discussed, the SEC's overarching concern is that a registered fund could be disadvantaged in the co-investment context. As the Staff recognized in the 1992 Report, this aim clearly can be met while still permitting co-investment transactions under certain

defined circumstances. The Staff could dramatically improve access co-investment opportunities for registered funds by taking a broad principle-based no-action position, as was the case with Non-Negotiated Co-Investments. All Co-Investment Programs are designed to ensure that both a registered fund's adviser and board, each of which owes a fiduciary duty to the fund, vet a transaction with a focus on ensuring that the registered fund is not being disadvantaged. There does not seem to be any clear reason why a no-action position that incorporates the common restrictions and concepts underpinning Co-Investment Programs could not achieve the same regulatory purpose as individual exemptive orders.

We believe the Staff should take a no-action position stating that it will not recommend enforcement action under Section 17 or 57 of the 1940 Act if registered funds co-invest in portfolio companies with each other and with affiliated private funds pursuant to a program based on certain general characteristics, including several concepts currently included in existing Co-Investment Programs. Such principles might include concepts such as:

Fiduciary Duties

Each adviser will manage the assets of each of its clients in accordance with its fiduciary duty.

Same Terms

Each affiliated fund participating in a co-investment will invest on the same terms.

Allocation Process and Conflict Policies

Advisers should have policies and procedures adequately designed to ensure that as co-investment opportunities arise falling within a registered fund's board-established criteria, the registered fund's portfolio management team is notified of the opportunity and receives the same information as other private funds.

Board Reporting and Compliance

The independent directors of a registered fund should receive quarterly information regarding all potential co-investment transactions that fell within the registered fund's board-established criteria, but were either declined by the registered fund or not made available to it.

Additionally, on an annual basis, each registered fund's chief compliance officer and board of directors should review and evaluate the fund's compliance with the no-action relief and the policies and procedures established to realize such compliance. However, the SEC should avoid dictating the requirements of a registered fund's compliance program, retaining the flexibility for the fund and its adviser to create a program that is reflective of the organization's unique structure.

Ethical Walls and Conflicts of Interest

Each adviser to a registered fund should adopt sufficient ethical wall policies to address conflicts of interest, insider information and confidentiality issues, including policies to address conflicts arising from investing in different parts of an issuer's capital structure.

The rapid evolution of co-investment orders over the past few years has resulted in a situation where exemptive relief is no longer the best regulatory option for permitting Co-Investment Programs. The issuance of a no-action position described above would not remove exemptive orders from the SEC's tool kit, but would instead allow the Staff to focus on more novel requests related to this complex issue.

# Key Themes in Comments on SEC Proposals Regarding Standard of Conduct for Broker-Dealers and Investment Advisers

Earlier this year, the SEC issued a package of regulatory proposals interpreting and enhancing the standards of conduct for broker-dealers and investment advisers. In our previous Alert, we focused on the SEC's interpretation of advisers' standards of conduct. In this Alert, we will summarize the industry response to the proposals based on comment letters that were submitted to the SEC.

By the expiration of the 90-day public comment period, the SEC had received:

- nearly 150 comments to the proposal relating to the SEC's interpretation of the fiduciary duties owed by investment advisers to their clients;
- over 2,500 comments to the proposal relating to enhancing broker-dealers' standards of conduct towards retail clients; and
- over 270 comments to the proposal relating to new disclosure requirements for advisers and broker-dealers on Form CRS.

The SEC has continued to receive additional comments since the expiration of the formal comment period.

This Alert summarizes three primary concerns noted in comments to the proposal interpreting advisers' fiduciary duties towards their clients. The comments consistently noted:

1. the inconsistency between the proposal's interpretation of advisers' duty of loyalty and established precedent;
2. the need for further clarification on advisers' abilities to define the scope of the advisory relationship by contract and on the meaning of "informed consent" with respect to conflicts of interest; and
3. the lack of distinction between fiduciary duties owed to retail and institutional clients.

This Alert also summarizes, at a high level, the concerns noted in comments to the proposals relating to broker-dealers' standards of conduct and Form CRS.

## Proposed Investment Adviser Interpretation

*The proposal's interpretation of advisers' duty of loyalty is inconsistent with established precedent and industry practices.*

The proposal interpreted the duty of loyalty broadly to require an adviser to put its clients' interests ahead of its own and to refrain from unfairly favoring one client over another. To meet this duty, the proposal required that an adviser make "full and fair disclosure to its clients of all material facts relating to the advisory relationship." In this regard, the proposal is consistent with the U.S. Supreme Court's decision in *SEC v. Capital Gains Research Bureau*, in which the Court noted, "[c]ourts have imposed on a fiduciary an affirmative duty of 'utmost good faith, and full and fair disclosure of all material facts,' as well as an affirmative obligation 'to employ reasonable care to avoid misleading' [its] clients."

But the proposal goes one step further by suggesting advisers should eliminate conflicts that are too complex to disclose with sufficient specificity. Several commenters noted that this interpretation is inconsistent with Capital Gains, which provided that the Investment Advisers Act of 1940 (the "**Advisers Act**") reflects "a congressional intent to eliminate, *or at least to expose*, all conflicts of interest which might incline an investment adviser – consciously or unconsciously – to render advice which was not disinterested [emphasis added]." Commenters pointed to this language as evidence that clear disclosure of conflicts should be sufficient without the need to eliminate such conflicts. As one commenter noted, "the suggestion that some conflicts are too complex for an investment adviser to be able to fulfill its fiduciary duty through disclosure is not supported in the law."

Advisers address complex conflicts in a number of different ways. For example, firms may erect information walls to restrict an adviser's access to material non-public information ("**MNPI**") obtained by affiliates, including requiring that employees certify that they do not and have not shared MNPI. To further address this conflict, the adviser may disclose that it could be deemed to possess MNPI, despite the fact that such MNPI was obtained by an affiliate. In addition, strategic relationships between firms and investors whereby an investor makes capital commitments to an adviser and multiple affiliates often give rise to complex conflicts due to the additional rights that inure to the benefit of the investor in consideration of its aggregate commitment. Advisers typically address these conflicts by clearly disclosing the existence and implications of strategic relationships.

The proposal's suggestion that certain conflicts are too complex or expansive to be understood by clients is inconsistent with industry practice and existing disclosure requirements. When completing Form ADV, advisers are required to disclose conflicts in plain English and instructed to use tables or bullet lists for complex material and to avoid legal jargon or highly technical business terms unless advisers explain them or believe their clients will understand them.

In sum, the industry emphasized to the SEC that the proposal's suggestion that disclosure and informed consent may be insufficient to satisfy an adviser's fiduciary duty of loyalty is inconsistent with the current state of the law and industry practice.

*The SEC should clarify advisers' abilities to define the scope of the advisory relationship by contract and the meaning of "informed consent" with respect to conflicts of interest.*

Commenters highlighted inconsistencies between the proposal and industry practice, in addition to within the proposal itself, with respect to an adviser's ability to define the scope of its duties through contract, and the proposal's lack of specificity when describing what constitutes "informed consent," which the proposal did not clearly define.

While the proposal explained that advisers and clients may shape their relationship through contract when the client receives full and fair disclosure and provides informed consent, it goes on to assert that an adviser "cannot disclose or negotiate away, and the investor cannot waive, the federal fiduciary duty." One commenter noted that this assertion is not supported by any case law or the realities of the marketplace, explaining that advisers often engage in practices that present potential conflicts that could be inconsistent with their fiduciary duties (*e.g.*, using client brokerage commissions to pay for research that may not directly benefit the client) after clearly disclosing such conflicts and obtaining client consent via contract; however, in these cases, the adviser does not generally waive its duties as a fiduciary. This commenter suggested that, to avoid confusion over an adviser's ability to enter into agreements defining the scope of its services and duties, the assertion that an adviser "cannot disclose or negotiate away, and the investor cannot waive, the federal fiduciary duty" should be limited to situations involving a blanket waiver of all conflicts or the use of disclosure that is not reasonably designed to be full and fair to the client. Similarly, another commenter submitted that the SEC should clarify this assertion to reaffirm the ability of an adviser and its clients to contractually agree to terms that modify the scope of services and duties of the adviser, provided the client is given full and fair disclosure.

Commenters were critical of the proposal's lack of specificity regarding what constitutes "informed consent" and the process by which such consent is obtained. One commenter noted that this omission implies that whether a client's consent is "informed" is a highly subjective determination. The commenter stated that, for advisers that offer

a strategy or account to many different clients, making a subjective, case-by-case determination whether each client's consent is "informed" may be extraordinarily costly, if not impossible, and that it should be sufficient to infer informed consent if the adviser has employed reasonable care to avoid misleading its clients with respect to those conflicts. The commenter suggested that, assuming adequate disclosure, unless an adviser has reason to believe that a client does not understand or agree to the existence of the disclosed potential or actual conflict, the client's willingness to continue the business relationship should be deemed to be sufficient evidence of informed consent.

*The SEC should recognize that fiduciary duties may lead to different problems with respect to retail and institutional clients.*

Commenters expressed concern that the proposal did not distinguish between fiduciary duties owed to retail and institutional clients. In practice, such distinctions are commonplace. Advisers distinguish between retail and institutional clients when assessing the suitability of an investment for a particular client and describing conflicts of interest, for example. Disparate treatment resulting from differences in financial sophistication are appropriate to ensure clients receive advisory services tailored towards their respective goals, risk profiles and liquidity needs. With respect to disclosure, the SEC recognizes the appropriateness of such distinctions, instructing advisers to consider their clients' level of financial sophistication when completing Form ADV.

One commenter noted that the proposal's contention that certain conflicts may be too complex to be adequately disclosed weakens the historical reliance on disclosure that has served as a key underpinning of the Advisers Act. The commenter stated that this contention is unwarranted with respect to institutional investors that have received full and fair disclosure, and noted that the federal securities laws recognize that sophisticated investors do not require the same level of protection as retail investors (*e.g.*, "qualified purchasers" invest in unregistered funds and "accredited investors" participate in private offerings).

While the proposal interprets an adviser's duty of care to include a duty to make a reasonable inquiry into a client's level of financial sophistication to ensure the suitability of investment advice, it does not provide further guidance on the appropriateness of disparate conduct based on a client's sophistication. One commenter stated that the proposal's assertion that "[a]n investment adviser has a fiduciary duty to all of its clients, whether or not the client is a retail investor," suggests that advisers must treat institutional and retail clients the same and over-simplifies "the duties that have been articulated vis-à-vis different types of clients." In the proposal, such duties principally relate to the suitability of personalized investment advice in light of clients' varying risk tolerances.

The commenter noted that statements in the proposal "about the adequacy of disclosure and the ability to negotiate the scope of an investment adviser's duties appear to be aimed more at investment advisers' interactions with retail clients." This observation is consistent with Chairman Clayton's Statement at the Open Meeting on Standards of Conduct for Investment Professionals in April, where he stated that the SEC "has focused on how to best bridge any gaps between what retail investors reasonably expect from their investment professionals and what our laws and regulations require, while ensuring that investor access and investor choice are preserved."

Further highlighting the differences between retail and institutional clients, one commenter noted that the proposal interpreted an adviser's fiduciary obligations to require the adviser to make a reasonable inquiry into a client's investment profile and update it as necessary to reflect changes in circumstances, which may not apply to advisers to institutional clients. For example, rather than a subadviser to a fund periodically updating the fund's "investment profile," it would provide advice based on the terms of the subadvisory agreement and the fund's investment objectives. Similarly, the proposal interpreted an adviser's duty of care to include the duty to provide advice and monitoring over the course of a client relationship. The commenter believes that this interpretation is an overly broad statement of law given the variety of advisory relationships and models that exist, including institutional mandates that may be more limited or specific. Rather, the commenter suggested the SEC acknowledge that the extent of an adviser's advice and duty to monitor are established by agreement between the adviser and the client.

### Proposed Regulation Best Interest

Proposed Regulation Best Interest would a "best interest" standard of conduct for broker-dealers, requiring that broker-dealers act in the best interest of their retail customers without placing their financial or other interests ahead of their customers'. The proposal provides that the best interest standard would be satisfied if broker-dealers meet certain disclosure, care and conflicts obligations.

The relatively large number of individual comments to the proposal appear to be the result of an AARP campaign encouraging the public to submit comments requesting a higher standard than the one imposed by Regulation Best Interest. In AARP's own comment letter, it criticizes the proposal for failing to impose a fiduciary standard and pressed the SEC to better define the contours of the best interest standard. Regulation Best Interest does not definitively define "best interest," instead leaving broker-dealers to interpret the standard based on the facts and circumstances surrounding an investment recommendation. AARP encouraged the SEC to revise the proposal to adopt a fiduciary standard that would require that recommendations are made "solely in the interest" of the customer and with the "care, skill, prudence, and diligence that a prudent person acting in a like capacity and familiar with such matters would use," which was substantially the same standard adopted under the Department of Labor's now-defunct fiduciary rule.

Other commenters echoed this sentiment, noting concerns that Regulation Best Interest did not provide clear guidance on the types of conduct that would be impermissible under the new standard, and that such ambiguity subjects the standard to differing interpretations based on facts and circumstances.

### Proposed Form CRS Relationship Summary

Proposed Form CRS would require that advisers and broker-dealers provide a brief relationship summary to retail investors. While commenters generally supported requirements mandating clear disclosures about how financial professionals describe the retail customer relationship, they encouraged the SEC to adopt a less confusing, more flexible approach to disclosure. For example, one commenter noted that the proposed Form CRS for dually-registered broker-dealers and advisers could confuse investors by presenting information that may not be relevant to them, including a substantial percentage of retail investors who do not qualify for advisory services that require a minimum account balance.

The proposal also included two new rules under the Securities Exchange Act of 1934 aiming to reduce investor confusion in the marketplace for firm services. The first rule would restrict broker-dealers, when communicating with a retail investor, from using the term "adviser" or "advisor" in specified circumstances. The second rule would require broker-dealers and advisers disclose in retail investor communications the firm's registration status with the SEC. While these rules did not garner as much attention as its headline-grabbing counterparts, one commenter noted that the new rule restricting brokers' use of names, which is intended to reduce investor confusion, is unnecessary because proposed Form CRS would require clear and concise disclosure about the client relationship. The commenter also suggested that the new rule regarding registration status disclosure be eliminated because a firm would already be required to disclose its registration status in proposed Form CRS.

* * *

While the financial industry generally supports the proposals and welcomed the leadership of the SEC in enhancing and clarifying the standards of conduct applicable towards investment advisers and broker-dealers, commenters raised valid concerns that may result in a final set of rules and regulations substantially different from what was proposed. We will continue to monitor these developments and discuss them in future Alerts.

## SEC Chairman Jay Clayton Issues Reminder that Staff Guidance Is Nonbinding

SEC Chairman Jay Clayton issued a statement last month reiterating the Commission's longstanding position that "all staff statements are nonbinding and create no enforceable legal rights or obligations of the Commission or other parties." Staff of the Division of Investment Management ("IM") followed Chairman Clayton's lead by withdrawing letters[3] the Staff issued in 2004 related to proxy advisory firms. We discuss these curious developments below.

### SEC Staff Guidance Is Not Law

While unusual to see in writing from the SEC, Chairman Clayton's statement highlights a well-known legal principle – communications by the Staff are not law, nor are they rules, regulations or statements of the SEC. Rather, such statements represent the views of the Staff, which can evolve over time. The timing of Chairman Clayton's statement corresponds with similar statements by other federal agencies, indicating a broader communications effort by leaders of federal agencies.

> *"Communications by the Staff are not law, nor are they rules, regulations or statements of the SEC. Rather, such statements represent the views of the Staff, which can evolve over time."*

The Chairman's position applies to all Staff communications, including letters, speeches, responses to frequently asked questions and responses to specific requests for assistance.[4] The statement explains that Chairman Clayton

3. *Egan-Jones Proxy Services*, SEC Staff Letter (May 27, 2004) (Withdrawn); *Institutional Shareholder Services, Inc.*, SEC Staff Letter (Sept. 15, 2004) (Withdrawn).

4. The statement specifically identifies guidance updates from the Division of Investment Management as an example of a nonbinding statement.

recently instructed the directors of the Division of Enforcement and the Office of Compliance Inspections and Examinations to further emphasize to their staff the distinction between the Commission's rules and regulations, on the one hand, and Staff views on the other. Chairman Clayton encouraged engagement on Staff statements and documents, "with the recognition that it is the Commission and only the Commission that adopts rules and regulations that have the force and effect of law."

Likely the most significant news arising from Chairman Clayton's statement was his revelation that he recently instructed the directors of the enforcement and examination units to emphasize to their staff the legal distinctions between laws and rules, on the one hand, and Staff guidance, on the other hand. As market participants are well aware, SEC examiners routinely cite to Staff no-action letters and informal Staff positions when communicating purported deficiencies they identify in the course of an examination. If followed, Chairman Clayton's instruction should lead examiners to change practice and cite either to an actual law, rule or regulation for a particular deficiency or, in the absence of relevant law, refrain from finding deficiencies based on Staff positions. Perhaps we are overly optimistic, but another potential salutary effect of the statement could be a change of practice by IM's disclosure examiners. Many in the registered funds industry have received disclosure comments that have no source in any law or regulation. Effectively, disclosure examiners have made rules informally through the registration statement review process. This practice should change. The disclosure review process requires more centralized oversight to ensure compliance with the policies expressed in Chairman Clayton's statement.

### Withdrawal of Proxy Advisory Letters

The proxy advisory letters withdrawn by IM were first issued in response to requests for guidance from two proxy advisory firms during the first proxy voting season following the compliance date of Rule 206(4)-6 under the Advisers Act. That rule addresses an investment adviser's fiduciary obligation to its clients when the adviser has authority to vote their proxies. The rule requires, in relevant part, an investment adviser that exercises voting authority over client proxies to adopt policies and procedures reasonably designed to ensure that the adviser votes proxies in the best interest of clients. An adviser's policies and procedures under the Rule must address how the adviser resolves material conflicts of interest with its clients. To this end, the Rule's adopting release states:

> An adviser that votes securities based on a pre-determined voting policy could demonstrate that its vote was not a product of a conflict of interest if the application of the policy to the matter presented to shareholders involved little discretion on the part of the adviser. Similarly, an adviser could demonstrate that the vote was not a product of a conflict of interest if it voted client securities, in accordance with a pre-determined policy, based upon the recommendations of an independent third party. . . . Other policies and procedures are also available; their effectiveness (and the effectiveness of any policies and procedures) will turn on how well they insulate the decision on how to vote client proxies from the conflict.[5]

The proxy advisory firms sought clarity from the Staff regarding how an adviser should assess a proxy advisory firm's recommendation of a vote in light of a conflict of interest the proxy advisory firm may have with respect to an issuer. The letters provided guidance – not traditional no-action relief – stating that a proxy advisory firm's receipt of compensation from an issuer generally would not affect the proxy advisory firm's independence from an investment adviser for purposes of making voting recommendations concerning the issuer's proxies for the investment adviser's clients. Taken together, the letters indicated that an investment adviser could view a proxy advisory firm's recommendation not to be conflicted even though that firm received compensation from an issuer. This determination would be made on a case-by-case evaluation of the proxy voting firm's relationship with issuers, a thorough review of the proxy voting firm's conflict procedures, and/or other means reasonably designed to ensure the integrity of the proxy voting process.

Subsequent to the withdrawal of the letters, the Director of IM explained to a Congressional oversight committee that the withdrawal of the letters was intended to facilitate discussion at an upcoming SEC roundtable on the proxy process. In developing the agenda for that roundtable, the Staff determined to withdraw the proxy advisory letters immediately in light of developments since 2004, when the letters were first issued. The Director of IM further elaborated that the roundtable discussion about investment advisers' responsibilities in voting client proxies, and about potential conflicts of interest in voting recommendations made by the proxy advisory firms, would best be facilitated if the letters were withdrawn.

Importantly, IM did not withdraw Staff Legal Bulletin No. 20, which provides guidance on the

5. Proxy Voting by Investment Advisers, SEC Release No. IA-2106 (Jan. 31, 2003).

retention of proxy advisory firms.[6] This legal bulletin states that, when retaining a proxy advisory firm, an investment adviser could consider the robustness of the proxy advisory firm's policies and procedures regarding its ability to identify and address any conflicts of interest and any other considerations that the investment adviser believes would be appropriate in considering the nature and quality of the services provided by the proxy advisory firm. At the Congressional committee hearing, the IM director expressed her view that the legal bulletin provides guidance that is more consistent with Rule 206(4)-6 than the guidance contained in the now-withdrawn letters.

What is the key takeaway from the withdrawal of the letters? In our view, not much has changed. Investment advisers that currently engage in appropriate diligence of proxy advisory firm conflicts in accordance with Rule 206(4)-6 and Staff Legal Bulletin No. 20 should not be adversely affected by the withdrawal of the Proxy Advisory Letters. Investment advisers that rely on proxy advisory firms should continue to consider whether a proxy adviser is providing conflicted advice. This could continue to take the form of a consideration of the robustness of a proxy advisory firm's conflicts policies and procedures.

## SEC Considers Derivatives Rule Re-Proposal

As our readers may recall, in 2015 the SEC proposed a rule that was intended to restrict the use of derivatives by registered funds ("Proposal"). We previously discussed this proposed rule at length in our February and May 2016 Alerts. As proposed, the derivatives rule would have, among other things, required registered funds to adhere to one of two limits on derivatives use—an exposure- or risk-based limit. The exposure-based limit would have prevented a fund from having aggregate exposure to (i) derivatives transactions (based on notional amount), (ii) "financial commitment transactions" (based on total indebtedness), totaling more than 150% of its net asset value. The proposed risk-based limit would have allowed a fund to have aggregate exposure of up to 300% of its net assets, so long as the fund's derivatives positions reduced the fund's overall value-at-risk ("**VaR**"). The Proposal also would have established new asset segregation and risk management requirements related to derivatives.

Generally speaking, the fund industry had a strong negative reaction to the Proposal. After receiving over 175 comment letters on the proposed rule, including a letter from Simpson Thacher, and undergoing a change in presidential administrations and SEC leadership, the derivatives rule was removed from the SEC's Regulatory Flexibility Agenda ("**Reg-Flex Agenda**"), the formal agenda for SEC rulemaking. However, the derivatives rule recently reappeared on the Spring 2018 Reg-Flex Agenda, where it was noted that IM is "considering recommending that the Commission re-propose" the rule. Based on feedback from our clients, we understand that the Staff has begun actively reaching out to certain members of the industry who submitted comments on the Proposal for feedback as it considers a re-proposal of the derivatives rule.

This Alert lays out our predictions of, and suggestions for, the SEC's re-proposal of the derivatives rule. Overall, we anticipate that the SEC will move away from relying on notional limits in light of the significant concerns expressed by the industry in the comment process that notional exposure is an "imperfect" indicator and "not an appropriate measure" of leverage, economic exposure and risk"[7] and the impact of the rule on the ability of certain types of registered funds to continue to operate. Instead, the SEC should focus on a derivatives rule that is flexible enough to account for variation in fund investment strategies and that incorporates asset segregation, which the industry supports. However, if the SEC remains focused on notional exposure, we suggest that the SEC use notional exposure as a nothing more than a potential trigger for a fund to implement a derivatives risk management program (as opposed to a hard cap on derivatives use).

> *"The SEC should focus on a derivatives rule that is flexible enough to account for variation in fund investment strategies and that incorporates asset segregation, which the industry supports."*

### Asset Segregation

We expect that the SEC will, at a minimum, retain its focus on asset segregation in the new rule. In the Proposal, the SEC had proposed that funds segregate assets based on mark-to-market derivatives exposure plus risk-based buffers, which generally received support from the industry as a method to minimize any risk posed by registered funds' use of derivatives. Relying primarily on asset segregation is consistent with historical practices with respect to derivatives. The addition of a requirement to

6. *See* Staff Legal Bulletin No. 20 (June 30, 2014).

7. *See, e.g.,* comment letters submitted by Blackstone Alternative Investment Advisors LLC and the Investment Company Institute.

account for a risk-based buffer in segregating assets was a new concept, but the industry generally viewed this enhancement as a workable change. The main objection to the asset segregation requirements in the Proposal was that it would only allow funds to use cash and cash equivalents to count toward "qualifying coverage assets" that would satisfy the proposed asset segregation requirements.

A common theme in comment letters on the Proposal was that the SEC should expand the definition of qualifying coverage assets to be more in line with the range of assets that are permitted to be used for initial and variation margin for derivatives by U.S. and international regulators. This approach would allow funds to segregate a wide range of low-risk, low-volatility assets to cover derivatives transactions—specifically, high-quality government and central bank securities, high-quality corporate bonds and equities included in major stock market indicies. Industry comments also urged the SEC to follow internationally adopted guidelines that would allow highly liquid assets to count for segregation purposes after an appropriate haircut. Permitting a wider range of highly liquid assets to be used to meet coverage requirements would allow funds to continue to hold assets consistent with their investment strategy to minimize "cash drag" as discussed in the Investment Company Institute's (ICI) comment letter, while also addressing the SEC's concern that funds have sufficient assets available to meet their obligations even if their assets decline in value. We expect that the SEC will respond to the chorus of industry comments on this point and adjust the rule accordingly when re-proposed.

### Reduced Reliance on Notional Limits

Funds use derivatives for a host of reasons—to achieve cost-effective exposure to investments, to provide non-correlated returns to traditional, long-only products and for hedging and risk management purposes. Given these uses, and the strong industry response to the suggestion of a notional exposure limit on such use of derivatives, we predict that the SEC will move away from a notional cap and focus primarily on asset segregation. There is a chance, however, that the SEC suggests retaining some sort of additional restraints on funds' use of derivatives to prevent undue risk and speculation. The Staff may be grappling with the question of whether to impose a practical limit on leverage, which might require some degree of prudential regulation such as testing value at risk or stress testing.

While we would hope the SEC avoids incorporating notional amounts into a derivatives rule, as even the SEC has acknowledged that it is a "blunt measurement" that fails to account for differences in types of derivatives, if notional amounts are included in the re-proposal, we strongly suggest that the SEC avoid using notional amounts to impose a limit on the use of derivatives.

We propose instead that notional amounts only be used, if at all, as an indicator of when a fund is a sufficient user of derivatives to warrant the use of more sophisticated mechanisms to manage derivative risk effectively. For example, notional exposure might serve as a threshold that, if exceeded, would trigger the requirement to establish a derivatives risk management program with a derivatives risk manager who is independent from portfolio management. This approach, which only applies the risk management requirements to certain users, would be similar to the approach the SEC took in the liquidity risk management rule where funds that primarily hold highly liquid investments are subject to a reduced burden. A rule that mandates all funds that use derivatives to have a risk management program with a risk manager would be too over-inclusive and burdensome, so if the SEC feels compelled to retain some requirements tied to notional amounts, this might be an approach that could be workable in achieving the SEC's regulatory aims without unduly burdening the entire industry.

### Risk Management Program

With respect to risk management requirements, we believe that the SEC should make it clear in re-proposing a derivatives rule that a deviation from a derivatives risk management program will not be viewed as an automatic compliance violation by the SEC examination and enforcement staff. Many of the risk assessments that need to be made under such a program are inherently subjective, and therefore subject to second guessing (especially with the benefit of hindsight). It would provide significant comfort to the industry if the SEC made it clear, for example, that any person designated as derivative risk manager should 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.

If the SEC re-proposes a derivatives rule, we expect that the SEC will receive a significant amount of comment from the industry and other interested parties. Simpson Thacher will be actively monitoring progress with regard to a potential derivatives re-proposal and will address any developments in future Alerts.

# M&A Transactions

| Acquiror | Acquired or Target Company | Type of Transaction and Status |
|---|---|---|
| **American International Group, Inc.**, a finance and insurance corporation with approximately $498 billion AUM | **Covenant Credit Partners**, a North Carolina-based investment management company that oversees two CLOs through which it manages approximately $900 million of broadly-syndicated leveraged loan collateral | Acquisition (terms not disclosed) |
| **Dyal Capital Partners**, a division of Neuberger Berman Group focusing on acquiring minority equity interests in institutional alternative asset management businesses | **Vector Capital**, a global private equity firm specializing in transformational investments in established technology businesses with approximately $3.8 billion of capital under management | Acquisition of a passive, non-voting, minority stake (terms not disclosed) |
| **Federated Investors, Inc.**, a United States-based investment manager with 108 fund and a variety of separately managed account options and approximately $397.6 billion in assets | **Hermes Fund Managers Limited**, a U.K.-based asset manager serving the wholesale and institutional markets with approximate EUR 33 billion AUM | Acquisition of majority interest with a purchase price of approximately $350 million for a 60 percent interest will be funded through a combination of cash and an existing revolving credit facility, and put/call provisions for purchasing additional shares over the next three to six years |
| **Fidante Partners**, an international investment management business with approximately $56 billion in AUM | **Latigo Partners, L.P.**, a New York-based fund manager specializing in event-driven investing, including distress securities, special situations and long/short credit and equity investing | Acquisition of a minority interest (terms not disclosed) |
| **FIS Group**, a Pennsylvania-based institutional investment firm specializing in global and non-US strategies with approximately $5.6 billion in AUM | **Piedmont Investment Advisors, LLC**, a North Carolina-based institutional money management firm specializing in active, passive and structured beta equity strategies and core fixed income management with approximately $4.7 billion in AUM | Acquisition (terms not disclosed) |
| **Hellman & Friedman**, a California-based private equity firm that focuses on investing in business franchises and serving as a value-added partner to management | **Financial Engines**, an investment adviser with approximately $169 billion AUM | Acquisition through an all-cash transaction paying Financial Engines shareholders $45 per share in cash for an aggregate value of approximately $3.02 billion |
| **LaSalle Investment Management, Inc.**, a global real estate investment manager with approximately $60 billion AUM | **Aviva Investors' Real Estate Multi-Manager**, with approximately $7 billion AUM | Acquisition (terms not disclosed) |

# M&A Transactions *(continued)*

| Acquiror | Acquired or Target Company | Type of Transaction and Status |
|---|---|---|
| **LaSalle Investment Management, Inc.**, a global real estate investment manager with approximately $60 billion AUM | **Encore+ Fund**, a diversified Continental European real estate fund with a gross asset value of approximately EUR 1.7 billion | Acquisition of Aviva Investor's interest in the joint management of the fund whereby LaSalle will become sole manager (terms not disclosed) |
| **Schonfeld Strategic Advisors LLC**, an investment advisory firm with more than $20 billion in gross market value | **Folger Hill Asset Management**, a New York-based hedge fund with more than $1 billion in AUM | Acquisition in which Folger Hill's parent company, Leucadia National Corp. and its founder Sol Kumin will receive a revenue share in Schonfeld's fundamental equity business |
| **White Oak Equity Partners**, a New York-based private equity firm that purchases non-controlling GP interest in alternative asset manager firms with less than $2B in AUM | **FCO Advisors LP**, a limited partnership operating as a private municipal credit focused investment fund with more than $1 billion in AUM | Acquisition of minority interest (terms not disclosed) |

# 2nd Quarter 2018 Closed-End Fund Public Offerings

## Destra International & Event-Driven Credit Fund

| | |
|---|---|
| **Structure:** | Interval fund with quarterly repurchase offers of no less than 5% and no more than 25% of its outstanding shares |
| **Investment Objectives/ Policies:** | The Fund's investment objective is to provide attractive total returns, consisting of income and capital appreciation. The Fund seeks to achieve its investment objective by investing at least 80% of its total assets in credit related instruments and/or investments that have similar economic characteristics as credit related instruments. "Credit related instruments" include bonds, debt securities and loans issued by various U.S. and non-U.S. public- or private-sector entities, including issuers in emerging markets, derivatives and cash equivalents. The Fund will allocate its assets between two strategies: (i) Multi-Strategy International Credit and (ii) Event-Driven Credit. The Multi-Strategy International Credit strategy focuses on investments in non-U.S. credit related instruments. The Event-Driven Credit strategy focuses on investing in securities of companies facing a corporate, market or regulatory event. Such events include, but are not limited to, corporate events, such as restructurings, spin-offs, mergers and tender offers; significant litigation; initial and seasoned debt or equity offerings; launches of new products; regulatory changes; analysts meetings; earnings announcements; covenant issues; bankruptcies; corporate reorganizations; shareholder activism; and significant management and external changes that dramatically change the company's profit margins. There is no currency limitation on securities acquired by the Fund. The Fund uses the market value of its derivative contracts for the purposes of its 80% investment policy in credit related instruments. |
| **Manager:** | Destra Capital Advisors LLC |
| **Distributor:** | Destra Capital Investments LLC |

Simpson
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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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**David Blass** is a Partner in Simpson Thacher & Bartlett LLP's Investment Funds Practice. David is a leading regulatory lawyer in the funds industry and has advised on matters involving innovative registered funds products, Investment Advisers Act compliance, SEC examination and enforcement matters, and broker-dealer regulatory compliance. Prior to joining Simpson Thacher, David served as General Counsel of the Investment Company Institute (ICI), where he was responsible for the full range of legal and regulatory matters affecting the asset management industry, including investment company, capital markets, pension and tax issues. He also previously was Chief Counsel of the SEC's Division of Trading and Markets.

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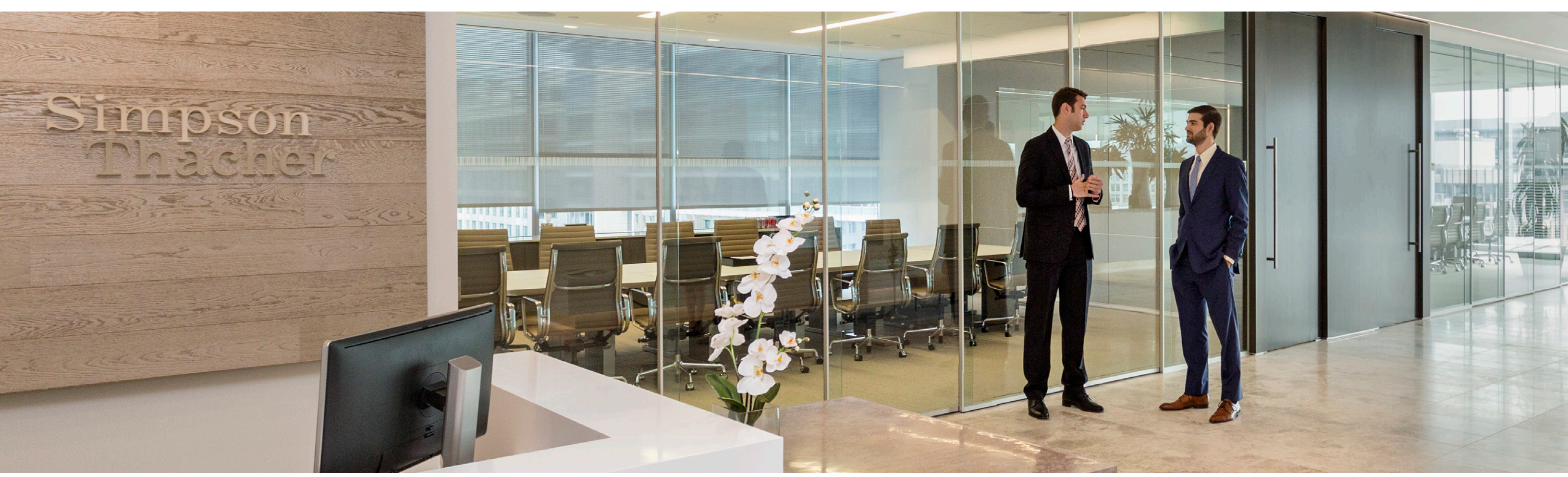

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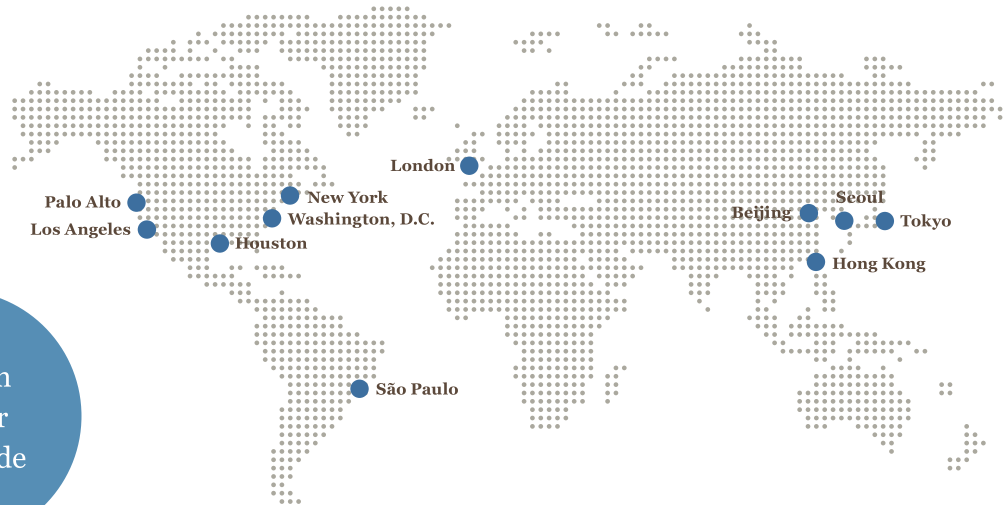


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