Simpson Thacher

Registered Funds Alert

September 2016

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This latest edition of Simpson Thacher's Registered Funds Alert discusses: AXA's win in its Section 36(b) trial and lessons for multi-manager funds and fund boards; the SEC's proposed rule on business continuity and transition plans; criticism from the fund industry on a multi-agency rule proposal aimed at regulating incentive-based compensation arrangements; and the SEC's recent clarification regarding the "Loan Rule" and its effect on independence of certain accounting firms.

AXA Wins Section 36(b) Trial; Takeaways Include Potential Improvements for Your Section 15(c) Process

On August 25, 2016, Judge Sheridan of the U.S. District Court for the District of New Jersey rendered his decision in *Sivolella v. AXA Equitable Life Insurance Company*, finding that the plaintiffs failed to meet their burden in demonstrating a breach of fiduciary duty under Section 36(b) of the Investment Company Act of 1940 ("1940 Act"). The AXA case was the first Section 36(b) case to advance to trial since the Supreme Court's 2010 unanimous decision in *Jones v. Harris Associates L.P.* that upheld the Second Circuit's well-established *Gartenberg* precedent.

The Plaintiffs alleged the adviser ("FMG," an affiliate of AXA) charged excessive advisory fees and administrative fees with respect to 12 funds. The plaintiffs' case focused on three arguments:

- FMG breached its fiduciary duty to the funds by charging fees that were disproportionate to the advisory and administrative services provided by FMG, as FMG delegated most of its duties to subadvisers and subadministrators that charged a lower fee;
- The funds' board breached its fiduciary duty by approving the disproportionate fees; and
- FMG manipulated the materials provided to the board in connection with the annual contract renewal process under Section 15(c) of the 1940 Act by providing misleading and unreliable information.

In order to prove a violation of Section 36(b) under the *Gartenberg/Jones* precedent, a plaintiff must show that the fee charged by the adviser is "so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining." There are six factors that a court generally considers in evaluating a Section 36(b) claim with respect to each fund:

(i) The nature and quality of the services provided by the adviser to the fund and its shareholders;

(ii) The profitability of a fund to the adviser;

(iii) "Fall-out" benefits realized by the adviser due to its relationship with the fund;

(iv) The economies of scale achieved by the fund as it grows in size and whether the adviser shares such savings with shareholders;

(v) Comparison of a fund's fee structure to similar funds; and

(vi) The independence and conscientiousness of the fund's board.

Plaintiffs need not prove that all of these factors weigh in their favor to prevail on a Section 36(b) claim. Additionally, the Supreme Court in *Jones* cautioned courts from placing too much weight on comparisons of a fund's fees to similar funds, as there is no guarantee that such fees represent fees negotiated at arm's length.

Section 36(b) claims are inherently tied to the board's annual contract renewal process pursuant to Section 15(c) of the 1940 Act. Generally speaking, Section 15(c) requires a fund's board to consider the renewal of an advisory agreement on an annual basis and imposes a duty on the board to request, and the adviser to provide, all information that may be reasonably necessary for the board to evaluate the agreement. Under *Gartenberg* and *Jones*, the decision of a fund's board, particularly its independent trustees, is given considerable weight by a court unless a plaintiff can show that the board's process was deficient or the adviser withheld important information from the board.

In finding for AXA with respect to each of the factors enumerated above, Judge Sheridan's decision heavily discounted the testimony of the plaintiffs' expert witnesses, citing errors, inconsistencies, lack of relevant experience, poor preparation and even "sarcastic demeanor" as reasons why little weight was given to their testimony.[1] In contrast, Judge Sheridan appears to have relied heavily on the testimony of the board's lead independent trustee and quoted him at length throughout the opinion.[2]

This Alert does not provide an in-depth review of Judge Sheridan's findings with respect to each *Gartenberg* factor, instead focusing on key takeaways for advisers and boards to consider in assessing the adequacy of their annual Section 15(c) process.

1. Notably, each of the plaintiffs' experts in the AXA case have been retained as experts by plaintiffs in a separate Section 36(b) case, pending in the same court (but before a different judge), against Hartford Investment Financial Services, LLC. The attorneys for both AXA and the plaintiffs also represent the parties in the Hartford case.

2. We note that the lead independent trustee, Gary Schpero, is a retired partner of Simpson Thacher who previously led our investment management practice.

Services Provided by the Adviser in a Multi-Manager Structure

A number of recent Section 36(b) claims have targeted advisers to multi-manager funds that delegate responsibilities to subadvisers, as FMG does, arguing essentially that the adviser is being paid without providing meaningful services. This line of argument relates most closely to the factor that focuses on the nature and quality of the services provided by the adviser. Judge Sheridan devoted a significant portion of his opinion to this topic (over 40 pages). In the AXA case, the plaintiffs argued that the plain text of the advisory and administrative agreements, when compared to the language of the subadvisory and subadministrative agreements, showed that FMG was delegating each and every one of its responsibilities.

The court found that the administrative contract language clearly indicated that FMG retained significant obligations. With respect to the advisory agreements, however, Judge Sheridan found that the contractual language on its face seemed to indicate a complete delegation of FMG's advisory responsibilities. In finding for AXA on this point nonetheless, the court relied on evidence showing that FMG retained many significant responsibilities not specified in the various advisory contracts, and found that AXA, an affiliate of FMG, provided significant services to the funds, the costs of which were borne by FMG. The overall services provided to the funds by FMG and AXA included:

- Supervision and management of subadvisers, including diligence and monitoring of performance;
- Construction and restructuring of portfolios;
- Setting benchmarks;
- Structural changes to funds (such as changing a fund's strategy or objective, terminating a subadviser or merging a fund);
- Formulating and implementing investment strategies for each fund (or sleeves of a fund);
- Asset allocation and rebalancing;
- Fair valuation for hard-to-value securities;
- Legal and compliance services;
- Preparing and managing board materials and meetings;
- Disaster recovery services; and
- Call centers to handle shareholder inquiries.

In light of this discussion in Judge Sheridan's opinion, it may be wise for advisers to compare the duties outlined in their advisory and subadvisory agreements (or other agreements). To the extent that this comparison shows an apparent delegation of all duties, an adviser should ensure that its Section 15(c) materials discuss any duties provided by an adviser that are not explicitly discussed in the applicable agreements. Additionally, advisers should consider public disclosure, including in shareholder reports, of the types of services provided to the funds they advise.

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The Board

In the AXA case, the court evaluated whether having an interested chair of the board undermined the board's independence and ability to fulfill its duties. The funds' lead independent trustee testified that he and the other independent trustees were, in reality, responsible for setting the agenda for board meetings, while the interested chair then carried out that agenda in running board meetings. While the court questioned whether an interested chair could realistically look out for the best interests of fund shareholders while simultaneously serving as CEO of the adviser, the fact that the board had a supermajority of independent trustees who demonstrated that they carry out their duties in a conscientious manner appears to have mitigated Judge Sheridan's concerns. The fact that the board meeting agenda was decided with input from the independent trustees also appears to have been an important factor in the court's decision. For other fund complexes, if the board has an interested chair but no lead independent trustee, it may be time to consider adopting that practice.[3]

Notably, Judge Sheridan also made a point of including a separate section in his opinion discussing

3. Judge Sheridan's opinion also implies that the appointment of Mr. Schpero as lead independent trustee was a result of the lawsuit, but this point fails to consider that he assumed that mantle from another trustee upon his retirement from the board.

how the filing of the lawsuit seems to have been the catalyst for several improvements to the board's practices and the Section 15(c) materials it receives in connection with annual contract renewals. For example, the opinion notes that the lawsuit appears to have resulted in a more critical review of board expenses, such as dinners associated with board meetings, and Judge Sheridan included a footnote recommending that the board adopt a policy regarding board expenses to ensure transparency regarding board-related costs. Additionally, the Judge stated that, since the commencement of the lawsuit, the board had begun receiving information in connection with the annual Section 15(c) process regarding the portion of the advisory fee that FMG retained after paying the subadviser,[4] and that the Section 15(c) materials were supplemented with an index of materials that tied each document to the relevant *Gartenberg* factor(s). While adoption of similar policies and practices cannot insulate a board from a Section 36(b) claim, they could prove to be helpful in the event a fund complex is sued.

The Plaintiffs in the AXA case have indicated that they intend to appeal the decision. We will continue to monitor this and other pending Section 36(b) cases (of which several are still pending, on similar and different fact patterns), and will address any notable developments in future Alerts.

SEC Proposes Rule Requiring Investment Advisers to Prepare a Business Continuity and Transition Plan; Issues Guidance Update Reflecting Similar Expectations for Registered Funds

As discussed in prior Alerts, the Securities and Exchange Commission is in the process of proposing a series of reforms designed to minimize certain perceived risks in the asset management industry. The most recent reform effort targets an alleged lack of adequate planning by some investment advisers to account for business disruptions. To address this concern, the SEC proposed Rule 206(4)-4 ("Proposed Rule") and an amendment to Rule 204-2 under the Investment Advisers Act of 1940, as amended ("Advisers Act"). If adopted, the rule changes would require SEC-registered investment advisers to: (i) adopt and implement a business continuity and transition plan; (ii) review the plan at least annually; and (iii) maintain a record of the current plan and any prior iteration of the plan in effect during the preceding five years, as well as other records related the adviser's annual review. The Proposed Rule appears to be aimed at smaller investment advisers, as larger and more sophisticated advisers likely already have business continuity measures in place. Comments on the Proposed Rule were due on September 6, 2016.

Key Components of a Business Continuity and Transition Plan

Under the Proposed Rule, a business continuity and transition plan must be reasonably designed to deal with operational risks such as cyber-attacks, system failures, natural disasters or acts of terrorism. Other operational risks may include those stemming from unexpected losses of service providers, facilities or key personnel. A business continuity and transition plan must address the following "key components" in the event of a significant disruption:

(i) maintaining critical operations and safeguarding data;

(ii) pre-arranging an alternate office location;

(iii) communicating with clients, employees, service providers and regulators;

(iv) assessing critical third-party services; and

(v) preparing a transition plan to sell, transfer or liquidate the managed assets.

Although the Proposed Rule requires all plans to address these key components, it recognizes that the degree to which a particular adviser's plan addresses each component will vary depending on the size and complexity of that adviser's business.

Maintaining Critical Operations and Data Protection

The Proposed Rule explains that a business continuity and transition plan should identify, prioritize and consider alternatives to critical operations in order to maintain continuity during a significant business disruption. Critical operations include those that are utilized for quickly processing transactions, delivering securities and maintaining client accounts. A plan should provide a contingency strategy for handling the temporary or permanent loss of key personnel. Additionally, data backup and recovery measures also should be incorporated into the plan, with an eye towards potential cyber-attacks

4. We note, however, that the record seems to reflect that this information was considered by the board prior to the commencement of the lawsuit.

and preserving key documents (*e.g.*, organizational documents, contracts and policies and procedures).

A notable aspect of the Proposed Rule is the extent to which it uses continuity planning as a platform to discuss cybersecurity issues. The Proposed Rule posits that the impact of cybersecurity incidents can be reduced by robust business continuity planning, and states that "[a]n adviser generally should consider and address as relevant the operational and other risks related to cyber-attacks." Language like this, interspersed throughout the Proposed Rule, appears to provide a basis for a new, independent cause of action that can be used by the SEC against advisers who fail to take sufficient steps to prevent, mitigate and respond to cyber-attacks. In any case, as we have noted in prior Alerts, advisers would be prudent to shore up their cybersecurity protocols in light of other recent SEC actions[5] and statements.[6]

Pre-Arranged Alternate Location

According to the Proposed Rule, a plan must "pre-arrange alternate physical location(s) of its office(s) and/or employees." Advisers should take into account the geographic diversity of different locations to preempt localized disruptions. Advisers should also consider how to maintain each location's remote access to technology and resources in order to continue with critical operations. This requirement generally applies to "extended" disruptions—consistent with past SEC guidance on this topic, enabling employees to work remotely is an appropriate plan for shorter disruptions. In the event of an "extended" issue, without providing any guidance on what period of time would constitute an "extended" period, the proposing release states that smaller advisers may be able to rely on remote access while larger advisers may need to plan to have an alternate location.[7]

5. *E.g., R.T. Jones Capital Equities Mgmt., Inc.,* Order, No. 3-16827 (Sept. 22, 2015) (imposing a $75,000 civil money penalty on an investment adviser for failing to failing to adopt sufficient procedures to safeguard customer information during a data breach); *Morgan Stanley Smith Barney LLC*, Order, No. 3-17280 (June 8, 2016) (imposing a $1 million dollar penalty on an investment adviser for failing to safeguard customer information during a cyber-attack).

6. Cybersecurity Guidance, IM Guidance Update, No. 2015-02 (Apr. 2015) (noting that "advisers should identify their . . . compliance obligations under federal securities laws and take into account these obligations when assessing their ability to prevent, detect and respond to cyberattacks"). *See also*, *e.g.*, Mary Jo White, Chair, SEC, *Opening Statement at SEC Roundtable on Cybersecurity* (Mar. 26, 2015); Kenneth Corbin, *SEC Warns More Cyber Enforcement Actions Coming*, *Financial Planning*, Apr. 20, 2016, (Andrew Ceresney, head of the SEC's Enforcement Division, explained, "[c]yber is obviously a focus of ours . . . we've brought a number of cases relating to Reg S-P and failure to have policies and procedures relating to safeguarding information . . . [t]here'll be others coming down the pike.").

7. As noted below, in the Guidance Update issued in tandem with the Proposed Rule, the SEC's Division of Investment Management apparently does not consider three days to be an extended period of time.

Communications

Another key component of a business continuity and transition plan is that it must address communications with clients, employees, service providers and regulators. The plan should consider different communication methods, and when and how to inform clients of significant business disruptions. Moreover, the plan should consider the process of communicating with service providers about disruptions that might affect the systems of both the investment adviser and the service provider.

Critical Service Providers

A business continuity and transition plan also must identify and assess third-party services in support of critical operations. An adviser could deem certain providers to be "critical" based on a variety factors including whether the service provider has backup systems, whether the service provider has direct contact with investors and whether the service provider has access to investors' personally identifiable information. The Proposed Rule explains that critical service providers would generally include those who offer services "related to portfolio management, the custody of client assets, trade execution and related processing, pricing, client servicing and/or recordkeeping and financial and regulatory reporting." The adviser should review and assess how critical service providers plan to maintain business continuity during a significant business disruption.

The distinction between critical and non-critical third-party service providers potentially puts advisers between a rock and a hard place. While the proposing release emphasizes that a business continuity and transition plan should entail robust diligence regarding critical providers, it does not elaborate on the specific protocols required for non-critical third-party service providers. The only clear guidance is that advisers should give more scrutiny to critical providers than non-critical ones. An adviser that applies a consistent, high-scrutiny approach to all providers, regardless of importance, may be left wondering whether it needs to differentiate its approach for critical providers, even if just in form, to avoid the appearance of not giving critical providers sufficient scrutiny.

Transition Plan

The final key component is a transition plan that considers how to transfer client relationships when an investment adviser exits the market or undergoes a change in ownership. Whether a transition occurs due to a merger, sale or an inability of the adviser to continue providing advisory services, a transition plan should be designed to facilitate a prompt, smooth transition in both normal and stressed market conditions. A transition plan should contain procedures for safeguarding client assets and handling client-specific information; it should also include an assessment of the applicable law and contractual obligations governing the adviser and its clients.

> *"Whether a transition occurs due to a merger, sale or an inability of the adviser to continue providing advisory services, a transition plan should be designed to facilitate a prompt, smooth transition in both normal and stressed market conditions."*

The Proposed Rule acknowledges that many advisers already have transition plans as a standard business practice and in compliance with parallel regulations. The concept of transition plans is of course well known to firms that are part of banking conglomerates, who have had to grapple with the concept of "living wills" in the post-financial crisis regulatory framework. However, the same concept, as applied to investment advisers, is inapt at best. Investment advisers invest assets for their clients, and follow stringent rules regarding the custody and safekeeping of those assets. A bankruptcy, sudden transition or other "black swan" event with respect to the adviser will not have any effect on the value of the assets held in client accounts. The investment management industry is robust, with several players. If an adviser were to fail, there are many others who would be ready to step in. Living wills and transition plans are particularly important to avoid government bailouts; it is difficult to imagine how a transition of an adviser could require a government bailout (indeed, after Lehman Brothers collapsed and went into bankruptcy at the onset of the financial crisis, its advisory arm was able to smoothly transition clients to Neuberger Berman without harm to investors). The Proposed Rule may serve a greater regulatory purpose for smaller advisers, which essentially would add to the category of business continuity disruptions the departure or incapacity of the adviser's owner or a key member of a small organization. For larger advisers, who employ investment teams and likely have a multitude of personnel who are capable of stepping in to ensure uninterrupted advisory services, and are unlikely to undergo any sort of meaningful transition without careful planning, even in extreme circumstances, the requirement for a written transition plan seems to us to be driven more by the regulatory pressures on the SEC from the other members of the Financial Stability Oversight Council, which noted its recommendation for a transition planning rule for investment advisers in its April 2016 update on its review of the asset management industry, than by the existence of an actual problem that requires a solution.

Accordingly, it seems unnecessary to require large advisers to have a detailed transition plan and the Proposed Rule is unclear with respect to what would qualify as a transition event that requires a written plan for larger advisers. For example, while a founder selling his or her controlling stake in an adviser is a manifest example of a transition event, what if an adviser's chief investment officer leaves? What about a junior portfolio manager? If the SEC insists on applying the transition plan requirement to large advisers, some guidance would be useful to assist advisers in this line-drawing exercise.

Annual Review

The Proposed Rule requires each adviser to perform a review of its business continuity and transition plan at least annually. The purpose of the review is to ensure the efficacy of the current plan and to consider whether the plan should be modified in light of changes to the adviser's products, operations, critical third-party service providers, structure, business activities, clients, or location.

Recordkeeping

Under the proposed amendment to Rule 204-2, advisers must maintain records of their current business continuity and transition plans and any prior iterations of their plans in effect during the preceding five years. An adviser must also maintain records related to the annual review. The records may be stored electronically, but advisers must keep copies to ensure easy access to necessary information during periods of stress and to facilitate review by SEC staff to check for compliance.

Companion Guidance Update for Registered Funds

On the same date as it issued the Proposed Rule, the SEC's Division of Investment Management published a separate Guidance Update pertaining to the business continuity plans of funds registered under the 1940 Act. Several recent system failures experienced by fund complexes served as an impetus for the SEC to issue this Guidance Update. For example, in August of 2015, a system failure of a third-party service provider resulted in clients of multiple fund complexes receiving stale pricing information over a three-day period. Although the Guidance Update did not appear to consider three days to be an "extended outage," it noted that an extended outage could have had a far greater negative impact. In the wake of these incidents, the SEC requested information from various funds and service providers, which revealed that some fund complexes appear to be unprepared to deal with extended outages of critical service providers. Accordingly, the SEC released the Guidance Update to discuss its general continuity planning expectations for fund complexes under Rule 38a-1 of the 1940 Act.

The continuity measures espoused in the Guidance Update for registered funds are similar to those in the Proposed Rule. For instance, the Guidance Update also emphasizes the importance of safeguarding business operations against potential system failures and cyber-attacks. Additionally, the Guidance Update defines critical service providers to registered funds to include at least "each named service provider under Rule 38a-1 (*i.e.*, each investment adviser, principal underwriter, administrator and transfer agent), as well as each custodian and pricing agent." Overall, the Guidance Update suggests that the SEC will hold funds and their control persons to similar standards as those expressed in the Proposed Rule.

SEC's Proposed Rule on Incentive-Based Compensation Arrangements Draws Criticism From the Fund Industry

In June 2016, the SEC and several other regulatory agencies published a revised rule proposal (the "Proposed Rule") on incentive-based compensation for covered financial institutions, which are those institutions with total consolidated assets (i.e., balance sheet assets) of at least $1 billion and includes asset managers. The Proposed Rule, which is mandated by Section 956 of the Dodd-Frank Act, calls for prohibitions on incentive-based compensation arrangements, or any feature of any such arrangements, that encourage inappropriate risks that could jeopardize the stability of the financial institution.

Under the Proposed Rule, an incentive-based compensation arrangement would be considered to encourage inappropriate risks that could lead to material financial loss to the covered financial institution unless the arrangement: (i) appropriately balances risk and reward; (ii) is compatible with effective risk management and controls; and (iii) is supported by effective governance. A compensation arrangement would not be considered to appropriately balance risk and reward unless: (i) it includes financial and nonfinancial measures of the covered person's performance; (ii) is designed in such a manner that it would allow, where appropriate, nonfinancial measures of performance to override financial measures of performance; and (iii) amounts awarded are subject to adjustment to reflect actual losses, inappropriate risks taken, compliance deficiencies, or other measures or aspects of financial and nonfinancial performance. For example, under the Proposed Rule a bonus structure that rewards covered employees for significant gains but offers no disincentives for significant losses would be potentially problematic because it does not appropriately balance risk and reward.

The Proposed Rule divides covered institutions by average total consolidated assets:

Level 1	≥ $250 billion
Level 2	≥ $50 billion and < $250 billion
Level 3	≥ $1 billion and < $50 billion

The sprawling 706-page proposal contains significant revisions from the initial 2011 proposal for regulation of incentive-based compensation, some of which have been well received. But several fund industry representatives submitted comment letters that argue the Proposed Rule is still too broad and captures certain investment advisers unnecessarily.

With respect to revisions that were embraced by the asset management industry, the Investment Company Institute ("ICI"), among others, commended the SEC for clarifying that investment advisers should include only proprietary assets in the calculation of consolidated assets and exclude non-proprietary assets, such as client assets under management, regardless of whether they appear on an investment adviser's balance sheet. This distinction was not clear in the 2011 proposal. Since the aim of the Proposed Rule is to curtail systemic risk that may be threatened if the financial institution becomes unsound, it is only the advisers' assets that are relevant, and not those of their clients.

Other portions of the Proposed Rule were met with more criticism. Possibly the most criticized component of the rule is its tiered system for classifying covered institutions based on size.

The Proposed Rule imposes increasingly detailed disclosure and record-keeping requirements for Level 1 and Level 2 entities and would require that incentive-based compensation arrangements for certain covered persons at such entities include additional features, such as clawback provisions, to appropriately balance risk and reward. These more stringent requirements affect two categories of individuals: "senior executives" and "significant risk-takers." At Level 2 institutions, "significant risk-takers" are those employees who derive at least one-third of their annual compensation from incentive-based metrics and fall among the top 2% of earners. At Level 1 institutions, however, such conditions apply to the top 5%. If an investment adviser were to be deemed to be a Level 1 or Level 2 institution, these requirements would likely impact key personnel, such as portfolio managers.

"Several comment letters critical of the proposal argue that this inflexible leveling system unfairly puts advisers who are affiliated with larger parent banks at a significant recruiting disadvantage relative to their standalone peers, and does so without regard to how they might actually operate."

Notably, an investment adviser that is a subsidiary of a banking institution could have its level dictated by the level that applies to the top-tier holding company. Several comment letters critical of the proposal argue that this inflexible leveling system unfairly puts advisers who are affiliated with larger parent banks at a significant recruiting disadvantage relative to their standalone peers, and does so without regard to how they might actually operate. If viewed on the basis of their own assets, most fund advisers subject to the rules would be Level 3; but those that happened to be under the umbrella of a larger bank would face stricter requirements solely because of that affiliation. Wells Fargo submitted a comment letter arguing that the result of the Proposed Rule would be that its asset manager subsidiaries will be forced to abide by tight Level 1 restrictions, while many of its subsidiaries' peers will only have to comply with Level 3 restrictions despite being "much larger and hav[ing] higher risk profiles."

The ICI's letter also argues that the rigid application based on size tiers does not properly account for the reality that many asset managers operate completely independent of their parent financial institutions. A potential fix put forth by the ICI would be to add an escape valve by which the SEC would have the discretion to treat a Level 1 or 2 institution as a Level 3 if it determines that the adviser's activities, complexity of operations, risk profile and compensation practices are consistent with those of a Level 3 adviser. This would allow for independent determinations in cases where the applicants believe circumstances warrant a different classification.

Comments on the proposal were due on July 22, 2016. Because of the multiagency basis on which these rules were proposed and will assumedly be adopted, it is unclear when these rules will be adopted, if at all, and the extent to which the SEC will have flexibility to apply the rules to asset managers in a manner appropriate to the asset management industry, as compared to the financial institutions that are the primary target of the rules.

SEC Questions Auditor Independence Under Loan Rule; Quickly Issues Temporary Relief

Under the 1940 Act, registered funds (including ETFs) are required to provide financial statements, which must be audited by an independent accounting firm, to their shareholders on an annual basis and file them with the SEC. The SEC has set forth strict requirements identifying what conditions must be met for an accounting firm to be considered "independent." The requirements are intended to ensure that accounting firms are qualified and independent of their audit clients both in fact and in appearance. Specifically, under Rule 2-01(c)(1)(ii)(A) of Regulation S-X, an accountant is not independent when:

> "[t]he accounting firm, any covered person in the firm, or any of his or her immediate family members has . . . [a]ny loan (including any margin loan) to or from an audit client, or an audit client's officers, directors, or record or beneficial owners of more than ten percent of the audit client's equity securities."

This is commonly referred to as the "Loan Rule."

For over a decade, the four major accounting firms, among others, have generally interpreted the Loan Rule as not being applicable in the registered fund context. Accordingly, an accounting firm would be independent with respect to a registered fund, even when a large shareholder of the fund, such as a financial institution, has lent money to the accounting firm. However, in May 2016, it was revealed that the SEC's Office of Chief Accountant and the Chief Accountant of the SEC Division of Investment Management indicated to certain accounting firms that they may be misinterpreting the Loan Rule. A change in the interpretation of the rule could have far reaching consequences for the fund industry. For example, the financial statements of many funds (who have been operating under the long standing interpretation of the Loan Rule) could be deemed deficient, given that the accounting firms would no longer be considered independent, and funds would be required to obtain a new (independent) audit and refile their financial statements.

In June 2016, however, the SEC granted temporary no-action relief addressing this issue. The relief allows fund complexes to continue to use financial statements audited by accounting firms that may not comply with the Loan Rule so long as certain conditions are satisfied.

First, the accounting firm must have complied with PCAOB Rule 3526(b)(1) and (2) ("Rule 3526(b)"), which requires the firm to describe to a client's audit committee on at least an annual basis all relationships between the accounting firm (or any of its affiliates) and the audit client or persons in financial reporting oversight roles at the audit client that may impact the accounting firm's independence and to discuss the potential effects of those relationships. The accounting firm must also confirm in writing that it meets applicable independence requirements. To the extent that Rule 3526(b) does not apply to an audited fund, the accounting firm must provide substantially equivalent communications.

Second, the SEC only granted relief for potential independence issues arising out of certain lending relationships:

(i) the financial institution that has lent money to the accounting firm holds more than ten percent of the shares of an audited fund (or an entity within the same fund complex);

(ii) an insurance company that has lent money to the accounting firm holds more than ten percent of the shares of an audited fund (or an entity within the same fund complex) in separate accounts that it maintains on behalf of its insurance contract holders; or

(iii) an institution that has lent money to the accounting firm and acts as an authorized participant or market maker to an audited fund (or an entity within the same fund complex) and holds of record or beneficially more than ten percent of the shares of the audited fund.

Finally, notwithstanding such non-compliance, the accounting firm must conclude that it is objective and impartial with respect to the issues encompassed within its engagement.

In relying on the relief, a fund is required to make reasonable inquiry regarding a lending relationship and its potential impact on an accounting firm's independence prior to submitting certain proxy proposals to fund shareholders, including (i) the election of trustees, (ii) the appointment of an independent accounting firm or (iii) any other proposal that similarly could impact the independence and impartiality of the independent accounting firm. The no-action letter includes an expectation that funds will adopt policies and procedures to provide for such an inquiry, which may require contacting institutions that owns a significant stake in a fund and has a lending relationship with the accounting firm. In this regard, the no-action letter notes that the initial request for relief included a representation that if a fund discovers that a lending institution owning more than 10% of a fund's outstanding shares actually exercises discretionary voting authority with respect to those shares, the fund would not be able to rely on the relief.

Notably, the SEC's no-action letter is explicit that the relief is temporary and expires in December 2017. The temporary nature of the relief suggests the Commission may consider modifying the Loan Rule prior to the relief's expiration. We will continue to monitor this issue and provide any significant updates in future Alerts.

M&A Transactions

Acquiror	Acquired or Target Company	Type of Transaction and Status
State Street Corporation, a provider of financial services to institutional investors with $2 trillion AUM	**GE Asset Management**, manager of General Electric Company's U.S. pension and benefit plans	Acquisition for $485 million (pending)
Union Bank & Trust, a subsidiary of Richmond, Virginia-based Union Bankshares Corporation	**Old Dominion Capital Management, Inc.**, a registered investmentadviser with nearly $300 million AUM	Acquisition (pending) (terms not disclosed)
Mesirow Financial, a financial services firm based in Chicago	**Fiduciary Management Associates, LLC**, a small- and mid-cap value equity money manager with $1.7 billion AUM	Acquisition (terms not disclosed)
Huatai Securities, a China-based securities group that provides wealth management, investment banking and asset management services, with a market capitalization of approx. $18.5 billion	**AssetMark Inc.**, a provider of investment and consulting solutions to financial advisors, with over $29.3 billion in assets	Acquisition for $780 million
D.A. Davidson & Co., a full service investment firm offering equity and fixed income capital markets services and advice	**SMITH HAYES Companies**, a financial services holding company with approx. $4 billion AUM and AUA that provides asset management services to institutions, wealth management services to individuals, and retirement planning and investment banking services to both municipal and corporate clients	Merger
Pacific Asset Advisors LLC, an investment management firm that offers life-insurance products, annuities, mutual funds and a variety of investment products and services	**Cadence Capital Management**, a boutique investment firm that manages approx. $4 billion on behalf of institutions, mutual funds and high net worth individuals	Acquisition (terms not disclosed)
Tortoise Credit Strategies LLC, a registered investment advisor, and key Bradford & Marzec LLC employees and management	**Bradford & Marzec LLC**, an investment advisor that manages long-only domestic and global fixed income portfolios for institutional and high net worth individuals	Partial management buyout by key Bradford & Marzec employees and management for 37%, while Tortoise will own the remainder (terms not disclosed)
BlackRock, provider of investment management, risk management and advisory services to institutional and retail clients, with $4.737 trillion AUM	Bank of America's asset management business, **BofA Global Capital Management**	Assignment of investment management responsibilities of approx. $80 billion AUM
Nuveen Investments Inc., an investment management firm specializing in helping financial advisors with affluent and high-net-worth investors	**Incapital LLC's Unit Investment Trust platform**	Acquisition (terms not disclosed)

M&A Transactions *(continued)*

Acquiror	Acquired or Target Company	Type of Transaction and Status
Foresters Financial, a Toronto-based international financial services provider that provides life insurance, savings, retirement and investment solutions to more than three million clients and has assets of approx. CAD $14 billion	**Aegon Capital Management Inc.**, an investment manager, and **Aegon Fund Management Inc.**, a mutual fund manager	Acquisition (terms not disclosed)
Angel Oak Capital Advisors, LLC, an investment management firm focusing on opportunities in fixed income, with $5.5 billion AUM	**Rainier High Yield Fund**, a U.S.-based investment manager offering equity and fixed income strategies	Acquisition (pending) (terms not disclosed)
Hennessy Advisors, Inc., a publicly traded investment manager that offers a range of domestic equity, specialty, balanced and fixed income products	**The Westport Funds**, which currently manage approx. $640 million of assets	Acquisition of assets related to the management of The Westport Funds (pending) (terms not disclosed)
Columbia Threadneedle Investments, an asset management group with $464 billion AUM	**Emerging Global Advisors**, a registered investment advisor based in New York with $892 million AUM	Acquisition (pending) (terms not disclosed)
Aegon, an international provider of life insurance, pensions and asset management	**BlackRock UK's defined contribution pension business**, which has approx. £12 billion of assets and 350,000 customers	Acquisition (pending) (terms not disclosed)
John Hancock Financial Network, Inc., a distribution channel of financial services company John Hancock	**Transamerica Financial Advisors, Inc.**, a Baltimore-based provider of life insurance, savings and retirement and investment solutions	Acquisition of certain assets of Transamerica (terms were not disclosed)
Hartford Funds, a provider of mutual funds and college savings plans	**Lattice Strategies**, an investment management firm based in San Francisco specializing in strategic beta exchange-traded funds with $215 million AUM	Acquisition (pending) (terms not disclosed)
C-III Capital Partners LLC, a commercial real estate services company that focuses on primary and special loan servicing, loan origination, fund management, CDO management, principal investment, investment sales and multifamily property management	**Resource America**, an asset management company specializing in real estate and credit investments, with $22.4 billion AUM	Acquisition for approx. $207 million
WisdomTree Investments, Inc., a New York-based exchange-traded fund and exchange-traded product sponsor and asset manager, with $43.0 billion AUM globally	**Boost**, a UK-based ETF provider	Buyout for $6 million

Closed-End Fund Initial Public Offerings

Nuveen High Income December 2019 Target Term Fund (NYSE: JHD)

Amount Raised (Inception Date):	$245 million (May 10, 2016)
Investment Objective/Policies:	The Fund's investment objectives are to provide a high level of current income exempt from regular federal income tax and to return $9.85 per share to Common Shareholders on or about March 1, 2021. The Fund's subadviser seeks to identify relative value in the market and select municipal securities across diverse sectors that are underrated or undervalued. In seeking to return the target amount on or about the Termination Date, the Fund intends to utilize various portfolio and cash flow management techniques, including setting aside a portion of its net investment income, possibly retaining gains and limiting the longest maturity of any holding to no later than September 1, 2021. As a result, the average maturity of the Fund's holdings is generally expected to shorten as the Fund approaches its Termination Date, which may reduce interest rate risk over time.
Managers:	Nuveen Fund Advisors and Nuveen Asset Management
Book-runners:	Morgan Stanley, Bank of America Merrill Lynch, Wells Fargo Securities and Nuveen Securities

Eaton Vance High Income 2021 Target Term Trust (NYSE: EHT)

Amount Raised (Inception Date):	$190 million (May 31, 2016)
Investment Objective/Policies:	The Trust's investment objectives are high current income and to return $9.85 per share per common share of beneficial interest, before deducting offering costs of $0.02 per Common Share, to holders of Common Shares on or about July 1, 2021. The Trust seeks to achieve its investment objectives by investing, under normal circumstances, at least 80% of its Managed Assets in corporate debt obligations and separately at least 80% of its Managed Assets in corporate debt obligations that, at the time of investment, are rated below investment grade (BB+ or lower) or are unrated but deemed equivalent by the Adviser. The Trust intends to utilize a limited duration strategy, which declines over time and is less sensitive to high yield interest rate risk than longer duration funds. The average maturity of the Trust's holdings is generally expected to shorten as the Trust approaches its Termination Date, which may reduce interest rate risk over time but which may also reduce amounts otherwise available for distribution to Common Shareholders.
Managers:	Eaton Vance Management
Book-runners:	Wells Fargo Securities, RBC Capital Markets and UBS Investment Bank

Simpson Thacher

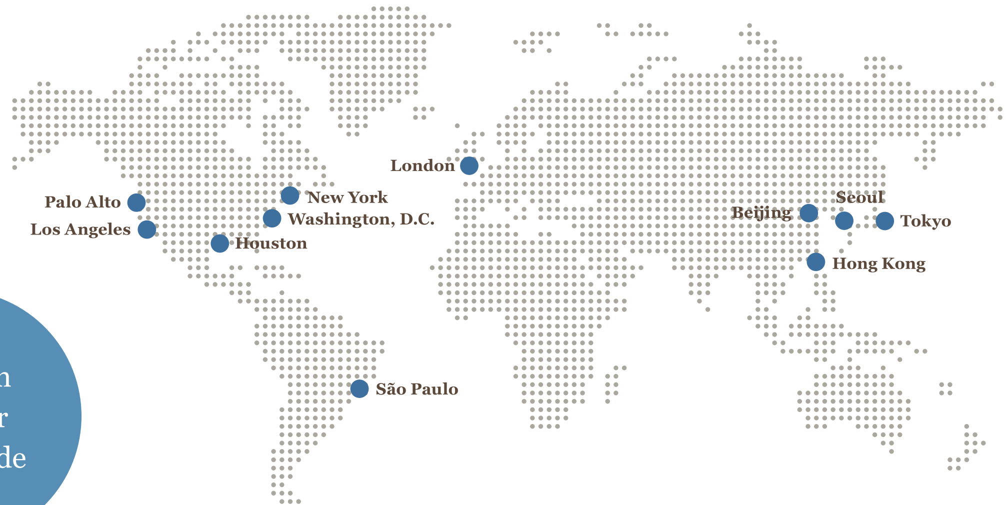
Simpson Thacher's dynamic, long-standing Registered Funds Practice encompasses all aspects of the investment management business. Our practice is multidisciplinary—it brings together such other areas as securities, mergers and acquisitions, banking, tax and ERISA.

Rajib Chanda • +1-202-636-5543 • rajib.chanda@stblaw.com

Rajib Chanda is a Partner in the Washington, D.C. and New York offices of Simpson Thacher & Bartlett LLP. Rajib's practice focuses on all aspects of issues facing registered investment advisers and sponsors of registered funds. Rajib has particular experience working with alternative asset managers seeking to access retail investor channels through mutual funds, business development companies, closed-end funds, exchange-traded funds and permanent capital vehicles. He also works extensively with more traditional registered fund sponsors and works closely with the firm's asset management M&A group on transactions involving registered advisers and funds. In addition, Rajib provides counsel to boards of registered funds, and has substantial experience advising companies on issues relating to social media and cybersecurity.

Sarah E. Cogan • +1-212-455-3575 • scogan@stblaw.com

Sarah Cogan is a Partner in the New York office of Simpson Thacher & Bartlett LLP and Head of the Firm's Registered Funds Practice. Sarah's practice encompasses all aspects of the registered funds industry and she represents closed-end investment companies, open-end mutual funds, investment advisers and independent directors of investment companies. She has a particular expertise in advising underwriters and sponsors in offerings by closed-end funds and business development companies. In addition, Sarah advises fund clients on corporate and securities law, including investment management, regulatory, compliance and M&A matters.



Simpson Thacher Worldwide

UNITED STATES

New York
425 Lexington Avenue
New York, NY 10017
+1-212-455-2000

Houston
600 Travis Street, Suite 5400
Houston, TX 77002
+1-713-821-5650

Los Angeles
1999 Avenue of the Stars
Los Angeles, CA 90067
+1-310-407-7500

Palo Alto
2475 Hanover Street
Palo Alto, CA 94304
+1-650-251-5000

Washington, D.C.
900 G Street, NW
Washington, D.C. 20001
+1-202-636-5500

EUROPE

London
CityPoint
One Ropemaker Street
London EC2Y 9HU
England
+44-(0)20-7275-6500

ASIA

Beijing
3901 China World Tower
1 Jian Guo Men Wai Avenue
Beijing 100004
China
+86-10-5965-2999

Hong Kong
ICBC Tower
3 Garden Road, Central
Hong Kong
+852-2514-7600

Seoul
25th Floor, West Tower
Mirae Asset Center 1
26 Eulji-ro 5-gil, Jung-gu
Seoul 100-210
Korea
+82-2-6030-3800

Tokyo
Ark Hills Sengokuyama Mori Tower
9-10, Roppongi 1-Chome
Minato-Ku, Tokyo 106-0032
Japan
+81-3-5562-6200

SOUTH AMERICA

São Paulo
Av. Presidente Juscelino
Kubitschek, 1455
São Paulo, SP 04543-011
Brazil
+55-11-3546-1000