Simpson Thacher

Registered Funds Alert

This edition of the Simpson Thacher Registered Funds Alert discusses recent developments in the registered funds industry, including an overview of the SEC's 2015 rulemaking and enforcement priorities, recent guidance relating to cybersecurity practices, proposed new hedging disclosure requirements and controversy regarding "bad actor" waivers. In addition, it discusses the SEC's increased comfort with innovative exchange-traded funds. Finally, we report on notable transactions that occurred in the first quarter of 2015, including M&A transactions and closed-end fund initial public offerings.

May 2015

2015 SEC Priorities and FY 2016 Budget Proposal Emphasize Examinations, Enforcement

The SEC's rulemaking priorities in 2015 include: (i) modernizing and enhancing data reporting for funds and advisers; (ii) imposing controls on registered funds to better identify and manage risks related to modern investment portfolios, including liquidity management and use of derivatives; and (iii) effective planning for possible impacts of market stress events and adviser transition plans. These initiatives reflect the SEC's effort to shift from its traditional rules-based regulation approach to a more prudential, risk-based approach. The SEC's proposed budget for FY 2016 indicates an increasing focus on examinations and enforcement activity. If approved, approximately 430 new SEC Staff employees would be hired and the vast majority of the new positions would be allocated to OCIE and the Division of Enforcement. (click here for full article)

Recent SEC Priorities Combine to Increase the Degree of Difficulty for Alternative Funds

The SEC's focus on alternative funds has been amplified by its emphasis on minor violations or "broken windows." The focus on nuanced requirements of the 1940 Act is showcased in the recent enforcement action against Water Island Capital for alleged violations, even though no shareholder harm occured. Other recent areas of emphasis that may affect alternative funds include: (i) an increased focus on mutual fund disclosure issues; (ii) concern regarding potential conflicts of interest with hedge funds; and (iii) the need to conduct stress-testing for fixed-income funds to ensure compliance with the 1940 Act's liquidity requirements. (click here for full article)

SEC and FINRA Report on Cybersecurity Sweep Examinations—Broker-Dealers Better Positioned than Advisers; SEC Issues Cybersecurity Guidance Update

Both the SEC and FINRA recently issued reports on cybersecurity practices following their respective sweep examinations. The SEC Report and FINRA Report each indicate that there likely will be an increased emphasis on cybersecurity issues in the coming years. A comparison of the reports also reveals that broker-dealers may be in a better position than advisers to handle the increased regulatory scrutiny, as they are more likely to have adopted written cybersecurity policies and procedures and to conduct periodic audits of their compliance with such policies and procedures. The SEC has urged funds and advisers to treat their cybersecurity policies as an ongoing compliance endeavor. (click here for full article)

SEC Proposal Would Require Listed Closed-End Funds to Disclose Hedging of Securities by Directors and Officers

The SEC recently announced proposed amendments that would expand the scope of existing hedging disclosure requirements to cover officers and directors of exchange-listed closed-end funds. Congress recently added directors to the scope of the hedging disclosure requirements under the Dodd-Frank Act, but the SEC has gone one step further by proposing to expand the requirements to include listed closed-end funds, a decision that has been met with some push back by the industry. (click here for full article)

SEC Approves New and Complex ETFs and Streamlined Listing Process, But One Commissioner Voices Concerns

Recent SEC actions, including the approval of “Paired Class Shares” ETFs, have indicated the SEC’s growing comfort-level with innovative ETFs. The SEC also recently proposed an amendment to the NYSE Arca listing standards that would establish generic listing criteria that would allow actively-managed ETFs to be launched without first receiving exemptive relief from the SEC. (click here for full article)

SEC Divided on “Bad Actor” Waivers

The SEC Commissioners are divided over the SEC’s practices in granting “bad actor” waivers. Commissioner Stein has been especially vocal in her dissent of the waivers process. Her objections center on the concern that the SEC may set a bad precedent that certain large financial institutions are “too big to bar” and can expect waivers even when faced with serious or repeated enforcement actions. (click here for full article)

1st Quarter 2015 Notable Transactions

List of notable transactions occurring in the first quarter of 2015, including M&A transactions and closed-end fund initial public offerings. (click here for full article)

2015 SEC Priorities and FY 2016 Budget Proposal Emphasize Examinations, Enforcement

SEC 2015 Priorities

In a speech, likely aimed in part at the Financial Stability Oversight Council (FSOC), at the SEC Speaks Conference on February 20, 2015, Mary Jo White, Chair of the Securities and Exchange Commission (SEC), outlined the SEC's 2015 rulemaking priorities. She indicated that the SEC Staff plans to release initial recommendations on the following topics: (i) modernizing and enhancing data reporting for funds and advisers; (ii) imposing controls on registered funds to effectively identify and manage risks related to modern investment portfolios, including liquidity management and the use of derivatives in mutual funds and exchange-traded funds (ETFs); and (iii) effective planning for possible impacts of market stress events or when an adviser is no longer able to provide advisory services.

More recently, in a series of speeches (found here and here), Dave Grim, Director of the SEC Division of Investment Management,[1] reiterated Chair White's priorities and expanded upon how they will affect the asset management industry, and advisers in particular. With respect to the asset management industry, Mr. Grim touched on the following specific initiatives:

- **Data Reporting**: According to Mr. Grim, the SEC Staff is currently considering ways to modernize data reporting by funds, including: (i) updating the information reported on Form N-SAR (which is still filed in MS DOS format) to reflect new market developments, products, practices and risks; (ii) improving the portfolio information reported on Forms N-CSR and N-Q to increase understanding of how funds are implementing their strategies and to help assess the adequacy of fund disclosures; and (iii) considering ways to standardize Form N-CSR and N-Q information regarding certain fund investment practices, such as use of derivatives and securities lending. Mr. Grim also cited the SEC's recent modernization of money market fund reporting, which requires monthly reports on Form N-MFP, as an example of how recent enhanced reporting measures have been successful.

1 At the time of these remarks, Mr. Grim was Acting Director. Chair White announced on May 8, 2015 that he would remain in that position as Director.

- **Derivatives Use**: Mr. Grim discussed some of the questions posed by the SEC in its 2011 Concept Release regarding use of derivatives by funds. He stated that the SEC Staff has been analyzing comments received in connection with the Concept Release and is considering measures that would require funds to "establish broad risk management programs to address risks related to their derivatives use."

- **Liquidity**: Mr. Grim stated that the SEC was considering revisiting liquidity management by mutual funds, noting that guidelines limiting open-end fund investments to no more than 15% of net assets are many years old. He explained that the Staff is focused on redemption rights of investors. In this connection, the SEC Staff is considering recommending "a new comprehensive approach to the management of the liquidity risks associated with fund portfolio composition" with the goal of providing better transparency to investors regarding liquidity risks associated with funds.

Regarding advisers, Mr. Grim noted the following priorities:

- **Data Reporting**: The SEC Staff is currently: (i) analyzing ways to improve the usefulness of Form ADV to investors and (ii) considering whether any additional information, such as information about separately managed accounts, should be reported on Form ADV to help the SEC's risk assessment efforts.

- **Transition Plans**: The SEC Staff is currently developing recommendations that would require advisers to create transition plans (in the event of a major disruption). Mr. Grim noted that plans should be tailored to any unique aspects of an adviser's business, addressing issues such as the departure of key personnel.

- **Stress Testing**: Mr. Grim noted that the Dodd-Frank Act requires the SEC to implement requirements for annual stress testing by large advisers and funds. He stated that the SEC Staff is developing recommendations for such requirements building upon lessons learned about stress testing through money market reform.

Taken together, these initiatives clearly indicate pressure from the FSOC for the SEC to behave more like a prudential regulator, like many of its cohorts on the FSOC, rather than the traditional rules-based regulator that it has been to date. The data gathering initiative can best be seen as an attempt to provide the SEC with a level of insight into the asset management industry that would justify its role as the primary regulator of the industry. The derivatives, liquidity management, transition planning and stress testing initiatives have clear analogues among the prudential regulators' regulatory regimes, and the statements in those regards indicate an intent to impose a risk-based analytic approach on the industry. Because risk-based analytics are necessarily dependent on the particular facts and circumstances of a fund, it follows that no "one size fits all" approach would be workable, and thus oversight of rules of this nature would draw the SEC further into the role of prudential regulator.

It is not clear, however, that the SEC will have the statutory authority to implement true risk-based, prudential regulations. The SEC's authority for such regulation, other than the Dodd-Frank requirement to impose stress-testing on pools of a certain size, would need to stem from one of the following three accepted avenues for rule-making: (i) statutory authority that explicitly grants the SEC power to adopt rules to effectuate the particular statutory provisions (for example, Section 17(d), which allows the SEC to effectuate rules regarding affiliated joint transactions); (ii) exemptive rules that can be conditioned on adopting standards imposed by the SEC (most famously, imposing fund governance standards in order to rely on several exemptive rules; Rule 2a-7 is another example); or (iii) disclosure requirements that can require disclosure of non-adoption of SEC-suggested practices (for example, disclosure if a fund does not have a policy on market timing). More controversially, the SEC could also claim a policy is required by Rule 38a-1 (the compliance rule) and prosecute firms for non-compliance with that rule or violations of written policies. None of these bases would seem to exist for, for example, the requirement for firms to stress test for liquidity in various interest rate environments. Given the recent successful challenges to SEC rule-making initiatives in the D.C. Circuit Court, we would expect the SEC to tread carefully in this area. But between these limitations on the one hand, and pressure from the FSOC on the other, the SEC must feel as if it is navigating between Scylla and Charybdis.

OCIE 2015 Priorities

In its Examination Priorities for 2015, the SEC Office of Compliance, Inspections and Examinations (OCIE) identified three "thematic areas" of priorities: (i) matters involving retail investors; (ii) assessment of market-wide risks; and (iii) using data to identify and examine registrants engaged in illegal activity, such as excessive trading. Below is a summary of OCIE's priorities as they relate to registered funds:

- Noting the "rapid and significant growth" of alternative funds, OCIE will continue to focus on alternative funds and will look at: (i) leverage, liquidity and valuation policies and practices; (ii) the adequacy of internal controls; and (iii) marketing practices.
- With respect to fixed income funds, OCIE noted the impending rise of interest rates and stated that it will review compliance policies and procedures related to investment and trading controls to ensure that fund disclosures align with a fund's liquidity profile and are not misleading.
- OCIE will continue focusing on cybersecurity in examinations of advisers and broker-dealers, and will expand its efforts to include transfer agents (as discussed in greater detail later in this Alert).
- OCIE will be conducting focused examinations on "never-before-examined" fund complexes (as also further discussed later in this Alert).

AMU 2015 Priorities

In her February 26, 2015, speech titled "Conflicts, Conflicts Everywhere," Julie M. Riewe, Co-Chief of the SEC Division of Enforcement's Asset Management Unit (AMU) provided an overview of the AMU's 2015 priorities. With respect to registered funds, Ms. Riewe listed a number of focus areas, including:

- Valuation of fund assets;
- Performance advertising;
- Deviation from fund investment guidelines or pursuing undisclosed strategies;
- Fund governance, including boards' and advisers' discharging of their obligations under Section 15(c) of the Investment Company Act of 1940 (1940 Act); and
- Fund distribution, including whether advisers are causing funds to violate Rule 12b-1 by making distribution payments outside of Rule 12b-1 plans.

Notably, Ms. Riewe specifically described several 2014 enforcement actions regarding performance advertising and Section 15(c), and stated that she expects there to be additional actions brought in these areas. As the title of her speech suggests, Ms. Riewe also discussed conflicts of interest related to registered funds, noting several 2014 cases related to advisers failing to seek best execution for fund clients. She noted that additional conflicts of interest cases are "in the pipeline" and stressed that advisers have a fiduciary obligation to identify, disclose and mitigate conflicts of interest.

SEC Budget for 2016 Fiscal Year

In February 2015, the White House released its budget proposal, which included a $1.722 billion funding request for the SEC. The request, if approved, would represent a nearly 15% increase over the SEC's 2015 fiscal year budget ($1.5 billion). A large portion of the increased funding request is allocated toward the hiring of approximately 430 new SEC Staff employees (as outlined in the SEC's FY 2016 Congressional Budget Justification). Given the SEC's increasing focus on examinations and enforcement actions, it is not surprising that a vast majority of the 430 new Staff positions have been allocated to OCIE and the Division of Enforcement, with the budget calling for 225 new examiners of advisers and 93 new Enforcement positions (although adding additional AMU personnel does not appear to be a priority). The SEC states that the increased funding for additional examiners would expand OCIE's examination potential, increasing the number of investment adviser examinations from around 10% in 2014 to an estimated 14% of all registered advisers once the new examiners are trained. Coupled with the SEC's focus on "broken windows," discussed below, the budget request indicates a strong likelihood of increased enforcement activity in the near future.

Recent SEC Priorities Combine to Increase the Degree of Difficulty for Alternative Funds

The SEC's growing focus on alternative funds is well documented, including in our prior Alert. Alternative funds have been featured in OCIE's annual list of priorities since 2013. In 2014, OCIE published a risk alert regarding due diligence and oversight of alternative investment managers as advisers and sub-advisers to mutual funds and announced a sweep examination of alternative funds. While these actions have attracted the bulk of the industry's attention, certain other SEC priorities also have implications for alternative funds.

Broken Windows

In October 2013, SEC Chair Mary Jo White declared that the SEC would have a renewed focus on minor violations of securities laws or "broken windows," harkening back to the famous strategy that Mayor Rudy Giuliani employed in his efforts to clean up the streets of New York City. The rise of alternative funds has attracted advisers with no previous experience advising registered mutual funds, meaning that these new advisers may lack experience with the nuanced requirements of the 1940 Act. A recent SEC enforcement action signals that alternative fund managers may be a target for the "broken windows" approach. On February 12, 2015, the SEC announced a settled administrative proceeding against Water Island Capital LLC (Water Island), which serves as an investment adviser and sub-adviser to various alternative funds. Although the relevant funds suffered no losses or other actual harm, the SEC order alleged that Water Island violated Section 17(f)(5), Section 12 and Rule 12b-1(h), and Rule 38a-1 under the 1940 Act by failing to implement policies and procedures that the funds had in place to abide by these regulations. The SEC noted that it discovered these issues during an examination of Water Island, but it is unclear whether this was connected with OCIE's sweep examination of alternative funds.

Section 17(f)(5) addresses the safeguarding of fund assets. If a fund maintains its portfolio holdings in the custody of a bank, its other cash assets must also be kept in bank custody. The SEC order states that Water Island's funds generally kept fund investments in the custody of a bank, thereby triggering the requirements of Section 17(f)(5). As Water Island's investment strategy involves the use of various derivatives, including swaps, the relevant funds were required to post cash as collateral for various swap agreements. The SEC order alleges that Water Island allowed approximately $247 million to be held in the custody of the broker-dealer counterparties to the swap agreements, instead of being held in the custody of the fund's custodian bank through a tri-party arrangement (the common industry practice).

Section 12 and Rule 12b-1(h) require an adviser to keep a list of approved brokers for executing fund transactions, and to document the relevant fund's compliance with directed brokerage requirements. The SEC order alleges that Water Island failed to create the required lists and did not maintain the required documentation.

The SEC order also includes a violation of Rule 38a-1, which requires funds to adopt and implement policies and procedures reasonably designed to prevent violations of federal securities laws. While the SEC order states that the relevant funds had adopted policies and procedures to address the requirements noted above, Water Island allegedly failed to implement those policies and procedures.

In a certain sense, the allegations against Water Island could be viewed as violations of "Mutual Funds 101." In a broader sense, however, the particular practices are unique to the mutual fund regulatory scheme, and a regulator with a different view of its mission may have treated these as deficiencies rather than as enforcement matters, particularly where no shareholder harm was alleged.

Disclosure, Conflicts and Fixed-Income

During a February 2015 webinar, Raymond Slezak, Assistant Regional Director of the SEC's New York Regional Office, discussed several other current and future SEC initiatives that have implications for alternative funds. One initiative is the SEC's increasing focus on mutual fund disclosure issues. Mr. Slezak stated that while the SEC would expect all funds to have accurate and complete disclosure that is presented in plain English, alternative funds could face a tougher task in meeting these expectations. For instance, alternative funds may change the way they implement their investment strategies as new derivative products enter the market. When that happens, alternative funds must make sure that their day-to-day investment strategy matches the fund's prospectus disclosure. Additionally, Mr. Slezak noted that alternative funds with multiple sub-advisers should be wary of marketing materials overstating the due diligence process regarding the fund's sub-advisers.

Conflicts of interest have also been on the SEC's radar, as evidenced by Julie Riewe's speech titled "Conflicts, Conflicts Everywhere," discussed earlier in this Alert. Mr. Slezak, expanding on this theme, explained that alternative fund advisers are often advisers to hedge funds with similar investment strategies, thus presenting the possibility for the mutual fund to be treated less favorably than a hedge fund (the latter of which often pays the adviser performance fees). He noted that the SEC has identified two particular risks in this area: (i) favoring hedge funds in allocating investment opportunities and (ii) allowing a hedge fund to take a short position in a security immediately prior to a mutual fund selling its interest in that security.

Additionally, the SEC has been vocal about potential liquidity issues and stress testing for fixed-income funds, in light of potential changes in interest rates. Mr. Slezak expressed his belief that alternative funds operating in the fixed-income space should be conducting stress testing to ensure that their portfolios can comply with the 1940 Act's liquidity requirements in changing market conditions. Given that alternative funds may be starting from a baseline of investing in less liquid investments than traditional funds, changes in interest rates could be more likely to cause alternative funds to run up against the 1940 Act's liquidity requirements. Mr. Slezak's comments presumably were focused on open-end funds, as opposed to closed-end funds and business development companies, which are common structures for alternative funds and not subject to particular 1940 Act liquidity requirements.

SEC and FINRA Report on Cybersecurity Sweep Examinations—Broker-Dealers Better Positioned than Advisers; SEC Issues Cybersecurity Guidance Update

The SEC issued a National Exam Program risk alert summarizing OCIE's cybersecurity examination sweep of advisers and broker-dealers on February 3, 2015 (SEC Risk Alert). On the same day, FINRA issued its report on cybersecurity practices of broker-dealers, based on its own sweep examination (FINRA Report). Neither the SEC Risk Alert nor the FINRA Report creates any new rules or legal obligations, but each provides insight into current industry practice.

Many commentators have interpreted the reported results as a sign that the industry is on top of cybersecurity issues, but OCIE specifically included cybersecurity controls among its examination priorities for 2015. Additionally, at various industry conferences and panels, members of the SEC's Division of Enforcement have mentioned the possibility of future enforcement actions relating to cybersecurity. A closer look at the SEC Risk Alert and FINRA Report reveals that broker-dealers may be in a better position than advisers in dealing with the anticipated increase in regulatory scrutiny of cybersecurity practices (although we of course are not expressing a view as to whether brokers are actually better positioned to prevent cyber-attacks than advisers). While that may not be surprising, given the significantly greater access brokers have to personal identifying information, advisers may nonetheless benefit from considering implementation of certain practices that have already been embraced by broker-dealers.

SEC Risk Alert

The SEC Risk Alert was the most recent step in the agency's ongoing cybersecurity initiative, which was formally announced in April 2014. During its sweep, OCIE examined 57 registered broker-dealers and 49 registered advisers. The SEC report indicates that OCIE attempted to capture a cross-section of each industry—the examined broker-dealers varied by number of registered representatives and types of services offered, while the advisers varied by amount of assets under management, client-type and whether they held custody of client assets.

The SEC report outlines the areas targeted in the sweep examination:

- Identifying risks related to cybersecurity;
- Establishing cybersecurity governance, including policies, procedures and oversight processes;
- Protecting firm networks and information;
- Identifying and addressing risks associated with remote access to client information and funds transfer requests;
- Identifying and addressing risks associated with vendors and other third parties; and
- Detecting unauthorized activity.

Written policies/procedures

In summarizing OCIE's observations, the SEC Risk Alert begins by noting that the vast majority of examined broker-dealers (93%), but fewer advisers (83%), had adopted written cybersecurity policies/procedures. In evaluating compliance with written policies/procedures, broker-dealers (89%) were much more likely to conduct periodic audits than advisers (57%). Similarly, broker-dealers (88%) are much more likely to refer to well-known cybersecurity risk management standards in developing their cybersecurity practices, such as the National Institute of Standards and Technology (NIST), International Organization for Standardization (ISO) and the Federal Financial Institutions Examination Council (FFIEC), than advisers (53%). Also according to the report, broker-dealers (93%) are more likely than advisers (79%), to conduct periodic cybersecurity risk assessments and consider them in establishing practices.

Vendors

In some of the most high-profile cybersecurity incidents (e.g., the Target breach), third-party vendors have been the gateway for attackers to access a company's systems. In the mutual fund arena, boards are increasingly asking advisers about their diligence and oversight of vendor cybersecurity practices. Thus, the disparity found in OCIE's report between broker-dealer and adviser practices with respect to cybersecurity is notable. As discussed above, broker-dealers are more likely than advisers to conduct periodic risk assessments regarding their cybersecurity practices. With respect to vendors, broker-dealers (84%) are significantly more likely to require vendors to conduct periodic risk assessments than advisers (32%). Similarly, broker-dealers (72%) are much more likely to incorporate cybersecurity provisions into contractual agreements with vendors than advisers (24%) and broker-dealers (51%) are more likely to conduct cybersecurity training for vendors who have access to their networks than advisers (13%).

FINRA Report

As outlined above, broker-dealers generally appear to be better positioned for future OCIE examinations or SEC enforcement initiatives related to cybersecurity than advisers. In light of that observation, advisers may benefit from some of the results and best practices stated in the FINRA Report, which focuses on the practices of broker-dealers.

Metrics

The FINRA Report states that almost all broker-dealers (95%) use metrics to assess cybersecurity performance. Examples of metrics cited in the FINRA Report are: distributed denial of services attacks; network intrusions; data theft; encryption coverage (e.g., portable devices, e-mail, etc.); Adobe and Microsoft patch coverage; anti-virus coverage; and employee training (both initial and ongoing).

Firms then set a threshold for certain metrics and manage their activities accordingly. The FINRA Report provides the example of a firm setting a threshold of keeping 95% of its computers up-to-date on Adobe and Microsoft patches (i.e., less than 90 days old). If the firm falls below that threshold, it would escalate the issue for prompt resolution. The FINRA Report suggests that cybersecurity metrics can be useful in developing cybersecurity practices, as the discussions and decisions about what to track, where to set thresholds and organizational reporting for issues may lead to more well defined policies/procedures.

Inventories

Both the SEC Risk Alert and FINRA Report espouse the importance of asset inventories as a foundational tool in establishing sound cybersecurity practices. Generally, advisers' practices were in line with broker-dealers with respect to conducting firm-wide inventories of physical devices and systems and software platforms and applications, but advisers lagged behind in taking inventories of: network resources; connections and data flows; connections to firm networks from external sources; hardware, data and software; and logging capabilities and practices. The FINRA Report notes that many broker-dealers maintain strong policies to ensure that all assets are subject to centralized review and control.

Vendor contracts

As discussed in connection with the SEC Risk Alert, broker-dealers are much more likely to incorporate cybersecurity provisions into contractual arrangements with vendors. The FINRA Report offers several examples of standard contract provisions for vendors that will have access to firm systems, addressing topics such as: non-disclosure/confidentiality; data storage, retention and delivery; breach notification responsibilities; right to audit clauses; vendor employee access limitations; use of sub-contractors; and vendor obligations upon contract termination.

Subsequent SEC Guidance Update

On April 28, 2015, the SEC Division of Investment Management issued a guidance update on cybersecurity. Citing OCIE's cybersecurity report, the guidance update begins by emphasizing the need for funds and advisers to review their cybersecurity practices. The tenor of the guidance update indicates that the SEC views cybersecurity as an ongoing compliance endeavor, where a "set it and forget it" approach might be inadequate. Among other considerations for funds and advisers, the guidance update recommends implementing written policies and procedures (citing Rule 38a-1), and training, with respect to the following measures:

- Funds and advisers should conduct periodic assessments of:
  - Technology systems and the nature, sensitivity and location of information collected, processed and/or stored;
  - Internal and external threats and vulnerabilities;
  - Controls and processes;
  - The potential impact of systems being compromised; and
  - Governance and management of cybersecurity risk.
- Funds and advisers should engage in strategic planning to prevent, detect and respond to cybersecurity threats, including implementation (and testing) of:
  - Access controls, such as authentication and authorization methods, firewalls and keeping software up-to-date;
  - Data encryption;
  - Restrictions on the use of removable storage devices, such as flash drives;
  - Software that monitors for unusual events;
  - Information sharing with vendors and industry groups, such as the Financial Services – Information Sharing and Analysis Center;
  - Data backup; and
  - Response planning.

Future SEC Examinations and Enforcement

The SEC has increasingly cited cybersecurity as an examination and enforcement priority. As noted, OCIE has listed cybersecurity compliance and controls among its 2015 examination priorities, and members of the SEC Staff have been dropping hints of impending enforcement activity in this area. Given the general lack of existing guidance and the evolving nature of this area, talk of potential enforcement actions is a bit alarming. For example, at an industry conference in early February, SEC Office of Market Intelligence Chief Vincente Martinez raised some eyebrows when he suggested that the SEC can rely on Regulation SP (Privacy), Regulation S-ID (Identify Theft) and Regulation SCI (Systems Compliance Integrity) to bring an enforcement action if a registered investment adviser's cybersecurity practices are deficient. Additionally, the SEC's recent guidance update states that the SEC Staff believes that funds and advisers have compliance obligations under federal securities laws related to preventing, detecting, responding and mitigating cybersecurity threats, citing again to Regulation SP and Regulation S-ID and also referencing Codes of Ethics rules, prohibitions on open-end funds from suspending shareholder redemptions and advisers' general fiduciary duty to clients to avoid the risk of being unable to provide advisory services.

We believe that any talk of enforcement is, at best, premature. Even if the OCIE report accurately reflects a greater attention to cybersecurity on the part of broker-dealers, as compared to advisers, it does not suggest a lack of attention. Indeed, for a variety of reasons, including high profile hacks, our experience suggests that the industry is taking its obligations with regard to cybersecurity very seriously. We note, in this regard, the creation of industry working groups to combat cyber threats. A high-profile enforcement action has the benefit, from the regulator's perspective, of focusing attention on an issue that is being ignored by regulated entities. However, cybersecurity is already a focus of industry participants, and enforcement actions in this area would in our view push the industry towards focusing on compliance policies at the expense of focusing on operational mechanisms to prevent cyber attacks in the first place.

SEC Proposal Would Require Listed Closed-End Funds to Disclose Hedging of Securities by Directors and Officers

On February 9, 2015, the SEC announced proposed amendments to Items 402 and 407 of Regulation S-K and Schedule 14A, which govern the requirements that an issuer disclose its employees' and directors' ability to hedge any decrease in the market value of the issuer's equity securities in proxy statements. The proposed amendments implement provisions of the Dodd-Frank Act that expand the hedging disclosure requirements. It is notable that the proposed amendments would not prohibit hedging by officers or directors, or impose any requirement that policies or procedures be adopted regarding hedging.

Current regulations do not apply the hedging disclosure requirements to directors or require funds registered under the 1940 Act (open-end or closed-end) to disclose such hedging, but do require all listed and non-listed business development companies (BDCs) to make the required hedging disclosures regarding certain executive officers. The SEC's proposed amendments would expand the scope of the hedging disclosure requirements to cover officers and directors of exchange-listed closed-end funds.

With respect to disclosure of hedging by directors, Congress forced the SEC's hand by explicitly adding directors to the scope of the hedging disclosure requirements in the Dodd-Frank Act. In expanding the requirements to include listed closed-end

funds, however, the SEC seems to have acted of its own volition. This expansion is viewed by many as controversial and unnecessary, as closed-end funds are significantly different from traditional operating companies historically covered by the disclosure requirements. While all five SEC commissioners voted to approve the rule proposals, Commissioners Gallagher[2] and Piwowar, both Republicans, released a joint statement voicing some concerns about the proposed rules, including their skepticism of the need to impose the hedging disclosure requirements on closed-end funds.

Comments on the proposed amendments were due on April 20, 2015. Among the 20 comment letters that the SEC received on this proposal, letters by the Investment Company Institute (ICI) and Mutual Fund Directors Forum (MFDF) addressed the question of closed-end funds.

The SEC's proposing release includes three reasons for expanding the requirements to listed closed-end funds, but not open-end funds. First, the SEC notes that, unlike open-end funds, closed-end fund shares trade at a price different from their NAV and are not redeemable from the fund. Second, the SEC stated that market participants have been found to engage in short sales of closed-end fund shares, which is unlikely (if not impossible) for open-end fund shares. Third, the SEC cites the fact that listed closed-end funds are required to hold annual shareholder meetings, while open-end funds are not. It is not clear why the first and third cited reasons, at least, explain why listed closed-end funds should therefore be subject to the hedging disclosure requirements.

Additionally, the proposing release does not address how closed-end funds fit within the stated intent of the Dodd-Frank Act amendments, which is to "allow shareholders to know if executives are allowed to purchase financial instruments to effectively avoid compensation restrictions that they hold stock long-term, so that they will receive their compensation even in the case that their firm does not perform." The SEC stated its belief that the Dodd-Frank Act amendments relate to "the alignment of shareholders' interests with those of employees' and directors'." Curiously, neither of these goals seems applicable to closed-end funds because of the way such funds are structured. As noted in the letters from the ICI and MFDF, closed-end funds have more characteristics in common with open-end funds than they do differences. The vast majority of funds are externally managed, meaning that they do not have employees, and appointed officers are often compensated by the fund's adviser, instead of the fund. With respect to fund directors, interested directors do not receive compensation from the fund and independent director compensation has no relationship to fund performance and fund shares are not usually issued as compensation. These structural characteristics appear to mitigate the concerns raised by Congress and the SEC. As closed-end funds seem to raise minimal concerns in this area, the ICI's comment letter also argues that the costs of implementing the necessary policies and procedures to ensure compliance with the hedging requirements would outweigh the any potential benefits to closed-end fund shareholders.

There have been no further developments since the comment deadline.

2 As this Alert was going to press, various press reports indicated that Commissioner Gallagher intended to resign as a Commissioner but that he would remain until a successor is confirmed.

SEC Approves New and Complex ETFs and Streamlined Listing Process, But One Commissioner Voices Concerns

Recent regulatory activity in the ETF space could signal the SEC's growing comfort-level with innovative ETFs. Notably, the SEC recently approved the adoption of new listing standards for "Paired Class Shares," a novel and complex actively-managed ETF product. Furthermore, the NYSE recently proposed a rule change that would allow certain qualified actively-managed ETFs to list and trade their shares on the NYSE Arca, Inc. (NYSE Arca) exchange without first seeking approval from the SEC's Division of Trading and Markets. Taken together with developments regarding non-transparent, actively managed ETFs discussed in a prior Alert, these developments are welcome respites (or potential respites, in the case of the rule proposal) from the cumbersome regulatory process associated with the development of ETFs.

SEC Approves "Paired Class Shares" Rule

On February 18, 2015, the SEC approved NASDAQ Rule 5713 allowing for the listing and trading of "Paired Class Shares" issued by seven new AccuShares ETFs on NASDAQ. The Paired Class Shares function via a novel and somewhat complex mechanism whereby the funds issue and redeem pairs of shares of opposing classes, described as "Up Shares" and "Down Shares." The values of the opposing classes move in opposite directions as the value of an "Underlying Benchmark," such as the CBOE Volatility Index. Up Shares are positively linked to the fund's Underlying Benchmark while Down Shares are negatively linked.

The SEC found that the proposed Rule was consistent with the requirements of the Securities Exchange Act of 1934, in particular that it was consistent with Section 6(b)(5) of the Act which requires, among other things, that NASDAQ's rules be designed to promote equitable principles of trade and in general protect investors and the public interest.

Notably, Commissioner Kara M. Stein dissented from the Commission's decision by voicing concern as to whether the rule as adopted would "in general, protect investors and the public interest" as required by Section 6(b)(5) of the Act. Commissioner Stein points out that similarly structured products have "imploded" in the recent past and casts doubt as to whether AccuShares has solved for these past problems. Furthermore, Commissioner Stein believes the complex distribution mechanism which the Paired Class Shares follow make it so that it is "difficult to envision a scenario where even the most sophisticated investors are not exposed to extreme risks."

NYSE Arca Proposed Rule Change

On March 4, 2015, the SEC published a notice soliciting public comments in connection with a proposed NYSE Arca rule change. NYSE Arca proposes to amend NYSE Arca Equities Rule 8.600 to adopt generic listing standards for securities issued by actively-managed ETFs (Managed Fund Shares). Under current NYSE Arca regulations, each new series of Managed Fund Shares must first seek approval from the SEC's Division of Trading and Markets before being listed and traded, a process that can often takes several months or longer. If approved, NYSE Arca would be able to list Managed Fund Shares without the additional burden of seeking a separate SEC approval, thereby significantly reducing the cost and time required to launch actively-managed ETFs. Comments on the proposed rule were due March 31, 2015.

The proposed rule would establish generic listing standard criteria for qualifying Managed Fund Shares, including certain requirements for derivative instruments. While there would be no limitation to the percentage of the portfolio that could invest in derivatives, at least 90% of an ETF's investments in futures and exchange-traded options must consist of futures and options for which the principal market is a member of the Intermarket Surveillance Group or a market with which NYSE Arca has a comprehensive surveillance sharing agreement. In addition, certain information must be disclosed on an ETF's website including a description of the ETF's holdings, identity of the asset upon which the derivative is based, the strike price for options, the quantity of derivatives held, maturity date, coupon rate, effective date, market value and the percentage weight of the derivatives in the ETF's portfolio. Finally, under the proposed rule Managed Fund Shares must have (i) a stated investment objective that must be adhered to under normal market conditions and (ii) its Portfolio Indicative Value widely disseminated by one or more major market data vendors at least every 15 seconds during the "Core Trading Session."

Outlook

The SEC Staff has noted on several occasions that a rule permitting ETFs to launch without exemptive relief is a priority, although it seems to have been de-prioritized in recent months. While such a rule, at least for traditional ETFs, is long overdue, the SEC's approval of non-transparent actively managed ETFs, "Paired Class Shares" and NYSE Arca's rule proposal suggest that regulators are becoming more familiar and comfortable with actively-managed ETFs. In contrast, Commissioner Stein's dissent regarding paired class ETFs is a sign that proposals for new and complex ETF products may face some resistance from the SEC if they expose investors to higher risks than traditional ETFs.

SEC Divided on "Bad Actor" Waivers

Recently, the SEC's practice of granting waivers related to various "bad actor" rules has become the center of a contentious debate among the Commissioners. Various securities law provisions provide streamlined securities offering procedures, and the "bad actor" rules restrict a party's ability to rely on such procedures if the party has engaged in certain disqualifying conduct. One such "bad actor" provision is Section 9(a) of the 1940 Act, which disqualifies investment advisers, directors and underwriters from serving in those capacities for any registered fund if they have a relevant criminal conviction, regulatory or court order, or other disqualifying event. A party that receives a waiver would avoid disqualification and be permitted to continue serving the fund. As the SEC has stepped up its enforcement activity under Chair White's "broken windows" approach, minor violations that result in enforcement actions or settlements may automatically result in a violation of bad actor rules. To borrow the words of SEC Commissioner Gallagher, for financial firms, failure to obtain a waiver in such circumstances could be akin to "a corporate death penalty."

The SEC's two non-chair Democratic Commissioners have become openly critical of how frequently bad actor waivers are granted. Last year, in connection with a waiver that was granted, Commissioner Stein dissented strongly, publicly noting her fears that the SEC "may have enshrined a new policy—that some firms are just too big to bar." Her opinion effectively set the tone of the ongoing debate. Since then, many commentators and politicians have echoed Stein's sentiments and have argued accusatorily that the SEC has been rubber-stamping waiver requests from large financial institutions that have faced serious or repeated enforcement actions. Commissioner Stein also recently suggested that more waivers should include conditions, such as hiring consultants.

The increasing internal and external criticism prompted Chair White to defend the bad actor waiver process in her address to the Corporate Counsel Institute on March 12, 2015. Chair White responded to Commissioner Stein directly, stating that no institution was "too big to jail or even too big to bar," but went on to stress repeatedly that, in her view, disqualification provisions were never intended to serve as an enforcement tool or to further punish underlying criminal conduct. Rather, she argued, the bad actor rules exist to protect the public from companies that are incapable of producing reliable disclosures. In the case of large financial institutions, the actual bad actors are usually a discrete set of individuals who can be separated from the firm as part of mitigation measures.

Commissioner Gallagher also defended the SEC's current practices and provided a useful history of bad actor provisions in a speech on February 13, 2015. He noted that the first bad actor rule was implemented in 1936, and the legislative history of later bad actor provisions shows a clear Congressional intent to keep "so-called 'bad actors' out of the industry, thereby preventing fraud." Commissioner Gallagher argued that the legislative history also demonstrates that the bad actor provisions are intentionally overbroad, which is why Congress allowed waivers to be granted in the first place. Further, when Congress expanded the SEC's sanctioning powers in 1990, disqualification waivers do not appear to have been considered. Thus, he argued, waivers should be granted "to those persons who are unlikely to abuse that relief through fraudulent or other improper conduct" and were never intended to be considered as part of the SEC's sanctions process. Commissioner Gallagher noted that the SEC Enforcement Division has adopted "an informal, non-Commission approved, practice" that prevents settlements from being conditioned upon the granting of a disqualification waiver. He took issue with this practice and stated that he will condition his vote on any enforcement proceeding on an understanding of whether a subsequent waiver will be granted.

The Commissioners' disagreements with respect to bad actor waivers have caught Congress's attention. A March 2015 legislative proposal floated by Representative Maxine Waters of California, the senior Democrat on the House Financial Services Committee, would rework the bad actor waiver processes to explicitly make any automatic disqualification a sanction and direct that waivers only be granted sparingly. Representative Waters' bill has yet to be referred to committee for consideration.

Chair White's view, along with Commissioners Gallagher and (assumedly) Piwowar, represents the majority position at this time. That said, companies seeking a waiver should take care to distinguish themselves from what she views as true bad actors by fully describing any remedial activities they have taken and explaining why, looking forward, the company will be able to produce reliable financial disclosures.

1st Quarter 2015 Notable Transactions

M&A Transactions

- **Mariner Wealth Advisors** announced that it acquired a majority interest in Pennsylvania-based **Vantage Investment Advisors, LLC**, a registered investment advisory firm that manages over $1 billion in assets on behalf of individuals, trusts, non-profits, businesses and pension plans.
- **Beacon Trust Company** announced that it agreed to acquire **The MDE Group, Inc.** and its affiliate, **Acertus Capital Management, LLC**, a registered investor adviser. Beacon is a wholly owned subsidiary of The Provident Bank, which in turn is a subsidiary of Provident Financial Services, Inc., an entity with approximately $8.4 billion in assets. The combined entities will manage, on a pro forma basis, approximately $2.5 billion in assets.
- **NASDAQ OMX** announced that it will acquire **Dorsey, Wright & Associates, LLC**, a firm focusing on data analytics, passive indexing and smart beta strategies, for $225 million. As a result, Nasdaq Global Indexes will become one of the largest providers of smart beta indexes with nearly $45 billion in assets benchmarked to its family of Smart Beta indexes and more than $105 billion benchmarked to all Nasdaq Indexes.
- **Ares Management, L.P.** announced that it completed its acquisition of Energy Investors Funds. As a result of the transaction, the Ares Private Equity Group has approximately $14 billion of assets under management.
- **Westwood Holdings Group, Inc.** announced that it reached an agreement to acquire **Woodway Financial Advisors**, a private wealth and trust company based in Houston, Texas that manages over $1.6 billion in private wealth client assets.
- Belgium's **Bank Degroof** announced that it signed a memorandum of understanding to merge with **Petercam**. The combined private banking entity would hold €47 billion assets under management.
- **Tavistock Group plc** announced that it entered into a conditional contract to acquire **Standard Financial Group Limited**, the holding company of Financial Limited, a financial advisory business. The acquisition will create a top-ten advisory group with over 300 financial advisers across the UK and 65,000 clients. The combined group's turnover will be over £30m and assets under advice are projected to grow from the current £400 million to over £3 billion.
- **AMG Wealth Partners, LP**, a subsidiary of Affiliated Managers Group, Inc., announced that it entered into an agreement to acquire a majority equity interest in **Baker Street Advisors LLC**, a San Francisco-based wealth management firm that advises approximately $6 billion in assets. AMG is a global asset management company that, through its affiliates, manages approximately $626 billion of assets.
- **Guggenheim Partners** announced the sale of **Guggenheim Global Trading** to an investor group led by GGT management. The new entity will operate under the name **Deimos Asset Management** and will be supported by an equity investment from Ares Management, L.P.
- **B. Riley Financial, Inc.** announced that it acquired **MK Capital Advisors, LLC**, an investment adviser that provides advisory services to ultra-high-net-worth families and individuals. The acquisition marks B. Riley's expansion into Wealth Management. B. Riley's other subsidiaries include B. Riley & Co. LLC, an investment bank which provides corporate finance, research, and sales & trading to corporate, institutional and high net worth individuals; Great American Group, LLC a provider of advisory and valuation services, asset disposition and auction solutions, and commercial lending services; and B. Riley Asset Management, LLC, a provider of investment products to institutional and high net worth investors.
- **BAWAG P.S.K.** announced the closing of its sale of **BAWAG P.S.K. INVEST**, its asset management unit, which has €5.0 billion of assets under management, to **Amundi Group SA**. The company's name will remain BAWAG P.S.K.INVEST, with a reference "Member of Amundi Group." In addition, Amundi and BAWAG P.S.K. entered into a long-term partnership where BAWAG P.S.K. will distribute Amundi's funds and continue to distribute INVEST products via its physical and digital distribution networks. BAWAG P.S.K. has the largest centrally managed branch network with 500 branches across Austria. Amundi will continue to operate INVEST in Austria.
- **Man Group plc** announced that it entered into a conditional agreement to acquire the investment management business of **NewSmith LLP**, an equity investment manager with $1.2 billion of funds under management.
- **Stifel Financial Corp.** (NYSE: SF) announced that it entered into a merger agreement to acquire **Sterne Agee Group, Inc.** for approximately $150 million. Sterne's 730 financial advisors and independent representatives and $20 billion in assets under management will join Stifel's Global Wealth Management

segment. As part of the transaction, Sterne will be selling the FBC Mortgage business back to its founders and will be operating its institutional equity and investment banking business as a stand-alone business until it is spun off.

- **Raymond James Financial, Inc.** announced that it reached an agreement to acquire **Cougar Global Investments, Ltd.**, a Toronto-based investment adviser. As a result of the transaction, Raymond James' wholly owned subsidiary, **Eagle Asset Management**, expects to offer Cougar's global asset allocation strategies to Eagle clients worldwide.
- **Threadneedle Investments** announced that its range of multi-manager funds will be transitioned to **Seven Investment Management** (7IM) to merge with funds managed by 7IM.
- **Peapack-Gladstone Financial Corporation**, the parent company of Peapack-Gladstone Bank, announced that it reached an agreement to acquire **Wealth Management Consultants (NJ), LLC**.
- **Vontobel Asset Management**, the asset management division of the Swiss private bank, announced that it reached an agreement to acquire a 60% interest in **TwentyFour Asset Management LLP**, with the remaining interest to be acquired by Vontobel over a longer term. The companies will have a combined CHF 17 billion of total fixed income assets under management.
- **Genstar Capital**, a middle market private equity firm based in San Francisco with total capital commitments of over $3 billion, announced that it agreed to acquire a majority interest in **Mercer Advisors Inc**., a Santa Barbara-based total wealth management firm with 15 branch offices across the country and approximately $6 billion in assets under management, from private equity firm Lovell Minnick Partners LLC.

Closed-End Fund Initial Public Offerings

Calamos Dynamic Convertible and Income Fund (NASDAQ: CCD)

- Amount Raised: $555 million
- Investment Objective/Polices: The Fund's investment objective is to provide total return through a combination of capital appreciation and current income. Under normal circumstances, the Fund will invest primarily in a portfolio of convertible securities (including synthetic convertibles, which are single instruments, or multiple instruments held in concert, that are composed of two or more securities with investment characteristics that, when taken together, resemble those of traditional convertible securities) and debt and equity income-producing securities, as well as other investments that generate current income and dividends, including but not limited to common and preferred stocks, investment grade and below investment grade (high-yield or "junk") bonds, loans, equity-linked notes, and floating rate securities (referred to throughout as "income-producing securities"). Under normal circumstances, at least 80% of the Fund's managed assets will be invested in convertible securities and income producing securities, with at least 50% of the Fund's managed assets invested in convertible securities (including synthetic convertible securities). The Fund will terminate on the fifteenth anniversary of the effective date of the registration statement, March 26, 2030, absent shareholder approval to amend the limited term provision of the Fund's Declaration of Trust, as provided therein.
- Manager: Calamos Advisors LLC
- Book-runners: Wells Fargo Securities, LLC, Merrill Lynch, Pierce, Fenner & Smith Incorporated, Ameriprise Financial Services, Inc., RBC Capital Markets, LLC

Goldman Sachs BDC, Inc. (NYSE: GSBD)

- Amount Raised: $138 million
- Investment Objective/Polices: The Fund's investment objective is to generate current income and, to a lesser extent, capital appreciation through direct originations of secured debt, including first lien, first lien/last-out unitranche and second lien debt, unsecured debt, including mezzanine debt and, to a lesser extent, investments in equities. The Fund invests primarily in U.S. middle-market companies, meaning companies with earnings before interest expense, income tax expense, depreciation and amortization (EBITDA) of between $5 million and $75 million annually. The Fund may from time to time invest in larger or smaller companies.
- Manager: Goldman Sachs Asset Management, L.P.
- Book-runners: Merrill Lynch, Pierce, Fenner & Smith Incorporated, Goldman, Sachs & Co. and Morgan Stanley & Co. LLC

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

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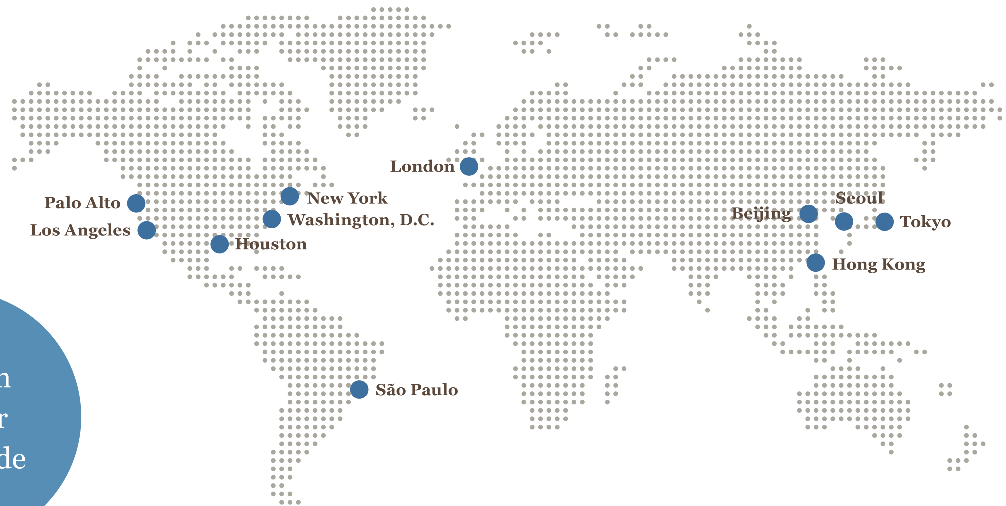

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