Simpson Thacher

Registered Funds Alert

This edition of the Simpson Thacher Registered Funds Alert discusses recent developments in the registered funds industry, including a new SEC proposal that would restrict the use of derivatives by registered funds, a summary of industry comments on the recent SEC proposal requiring open-end funds and ETFs to adopt liquidity management programs and the latest SEC guidance update relating to mutual fund arrangements with financial intermediaries. In addition, this Alert discusses the result of a three-way proxy battle for control of a publicly traded BDC and OCIE's 2016 examination priorities, including a discussion of their potential effect on registered funds and registered advisers. Finally, we report on notable transactions that occurred in the fourth quarter of 2015, including M&A transactions and closed-end fund initial public offerings.

February 2016

SEC Derivatives Rule Proposal is Unworkable for Many Alternative Funds

In December 2015, the SEC proposed a new rule aimed at restricting the use of derivatives by registered funds. The proposed rule would require registered funds to adhere to one of two limits on derivatives use—an exposure-based limit or a risk-based limit. The SEC also proposed new asset segregation and risk management requirements. This Alert focuses on several aspects of the proposal that are noteworthy for alternative funds and topics that we expect will be addressed in industry comment letters. (click here for full article)

Industry Advocates for Alternative Approach to Liquidity Management; Questions Whether Swing Pricing is Feasible

As discussed in our last Alert, the SEC recently proposed a new rule that would require open-end funds and ETFs (other than money market funds) to adopt liquidity management programs. Separately, the SEC also proposed to permit such funds to implement "swing pricing," which would allow a fund the option to adjust the net asset value applicable to purchasing or redeeming shareholders to pass along expenses associated with their trading activity. With the comment period closed, this Alert summarizes notable themes presented in comments from industry participants. (click here for full article)

SEC Staff Issues Distribution in Guise Guidance; Raises Questions Regarding Responsibilities of Advisers and Boards

The staff of the SEC's Division of Investment Management issued a guidance update in January 2016 addressing issues related to mutual fund arrangements with financial intermediaries. The guidance update places heavy emphasis on the duties of advisers to provide, and mutual fund boards to review, adequate information regarding payments made to financial intermediaries. The positions stated in the guidance update raise questions of whether advisers and boards need to modify existing practices with respect to the approval, renewal and oversight of Rule 12b-1 plans. (click here for full article)

Three-Way Proxy Battle for Control of a BDC Ends in Apparent Stalemate

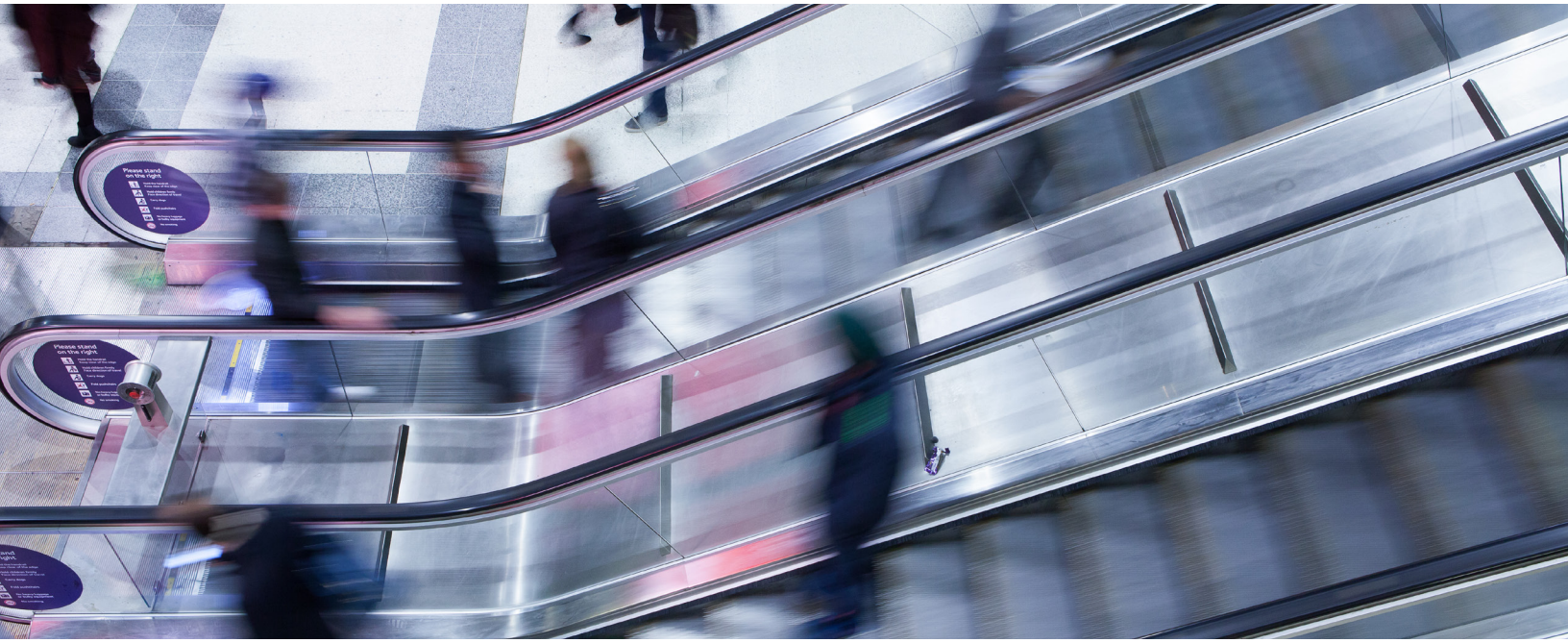
Over the past six months, a contentious three-way contest for control of a publicly traded business development company has been unfolding through proxy materials, the press and in court. This Alert summarizes the proxy contest, describing how parties used novel takeover strategies and discussing the unusually complex set of alternatives that were presented to shareholders. (click here for full article)

OCIE Announces 2016 Examination Priorities; Builds Upon Past Initiatives

In its Examination Priorities for 2016, the SEC's Office of Compliance, Inspections and Examinations organized its priorities within the same three "thematic areas" as its 2015 Priorities. This Alert summarizes the priorities related to registered funds and registered advisers. (click here for full article)

4th Quarter 2015 Notable Transactions

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



SEC Derivatives Rule Proposal is Unworkable for Many Alternative Funds

As we have discussed in previous Alerts, under pressure from the Financial Stability Oversight Council ("FSOC"), the Securities and Exchange Commission ("SEC") is in the midst of proposing a series of rules affecting the asset management industry designed to minimize the alleged systemic risk posed to the financial system by mutual funds. The SEC had indicated that it plans to propose five new rules (data reporting, liquidity management, derivatives management, transition planning and third-party examinations of advisers), and the recently proposed derivatives rule is the third of these.

In December 2015, the SEC proposed new Rule 18f-4 under the 1940 Act ("Proposing Release") aimed at restricting the use of derivatives by registered funds. Rule 18f-4 would be an exemptive rule, providing relief from the restrictions of Section 18 of the 1940 Act. Section 18 restricts the ability of registered funds to issue or sell senior securities.[1]

The Proposing Release is remarkable in several respects. First, the Proposing Release states that if Rule 18f-4 is adopted, the SEC will rescind all prior guidance regarding derivatives—including Investment Company Act Release 10666 and all no-action letters that have provided the foundation for the framework of funds' use of derivatives for over 35 years. Second, the Proposing Release openly acknowledges that Rule 18f-4, as proposed, would make it impossible for registered managed futures funds, some leveraged exchange-traded funds ("ETFs") and certain other types of registered alternative funds to continue to operate. To our knowledge, the SEC has never before proposed a rule that was designed to force specific types of funds to deregister, effectively putting them out of business or moving them into regulatory regimes other than the 1940 Act.

Rule 18f-4 would require registered funds to adhere to one of two limits on derivatives use—an exposure-based limit or a risk-based limit. The Proposing Release also sets forth new asset segregation and risk management requirements. This Alert will not explore all aspects of the proposed rule, instead focusing on several aspects of the proposal that are noteworthy for alternative funds. We expect that the SEC will receive comment letters addressing these points.

1. "Senior security" is defined in Section 18(g) as any bond, debenture, note, or similar obligation or instrument constituting a security and evidencing indebtedness.

Exposure-Based Limit

The exposure-based limit would prevent a fund from having aggregate exposure to: (i) derivatives transactions (based on notional amount); (ii) "financial commitment transactions"[2] (based on obligation amount); and (iii) any senior security (based on total indebtedness), totaling more than 150% of its net asset value.

The Proposing Release states that the 150% limit is "designed to balance concerns about the limitations of an exposure measurement based on notional amounts with the benefits of using notional amounts." There are at least three issues with the proposed limit: (i) it is not clear that notional amounts are the best metric for measuring risk or leverage in a fund portfolio; (ii) if the limit is based on notional amounts, 150% may not be the appropriate number; and (iii) the burdens of using notional amounts might outweigh the benefits.

Is Notional Amount the Best Metric For Measuring Derivatives Exposure?

By basing this limit on the notional amount of derivatives exposure, the SEC has proposed a one-size-fits-all limit that would curb derivatives use by registered funds. The SEC's primary argument for using notional amount is that a limit based on notional amounts is the easiest way to administer an exposure limit. There is no doubt that the SEC is correct that it is a simple, administrable test, and for many funds will be easy to implement. But administrative ease is not sufficient to justify rule-making; instead it is one factor to consider when weighing various alternatives.

Notional exposure does not in and of itself measure the risk of a fund's portfolio. This is true for a number of reasons. First, two different derivatives with the same notional exposure but different underlying assets have very different risk profiles; for example, an equity total return swap has a different risk profile than an interest rate swap. The SEC acknowledges this fact in the Proposing Release. Second, different derivative instruments may provide uncorrelated or inversely correlated returns to one another. A strategy using long equity derivatives and short equity derivatives may be designed to reduce risk, but by taking the absolute value of notional exposure for both, a fund using a notional exposure test will be treated as having greater risk than if it only held long or short positions.

2. The Proposing Release defines "financial commitment transaction" as any reverse repurchase agreement, short sale borrowing, or any firm or standby commitment agreement (or similar agreement). Any unfunded capital commitment to a private fund would also be deemed to be a financial commitment transaction.

In addition to not accurately measuring the risk of a fund's portfolio, it is also not clear that a notional exposure limit necessarily measures the leverage in a fund's portfolio. Take, for example, an equity total return swap. If there is a notional amount of $100, and the fund has no margin requirement, then the fund has leverage of $100. If the fund were to place $100 in a margin account, it would have no leverage; it would be the same as an investment in the underlying security. Whether the SEC views the purpose of Section 18 as a limit on risk or as a limit on leverage, notional exposure is at best an imperfect proxy for either such purpose. We expect significant industry comment that will, at a minimum, suggest that the SEC consider a more nuanced view of how to calculate a notional exposure limit.

Why is the Proposed Limit Set at 150%?

A significant portion of the Proposing Release attempts to justify the SEC's choice of 150% as the appropriate limit for derivatives exposure. There is not, however, any clear statutory basis that supports that particular number, as opposed to 167.3% (or *any* other number). The Proposing Release states that the SEC believes that using "an appropriate exposure limit" is important, and that the SEC has determined that 150% is appropriate. The statutory bases cited to support the 150% limit are (i) Sections 1(b)(7) and 1(b)(8) of the 1940 Act, which state that the national public interest and interest of investors are harmed when excessive borrowing and the issuance of excessive amounts of senior securities increase unduly the speculative character of funds' junior securities and when funds operate without adequate assets or reserves, and (ii) Section 18 of the 1940 Act, which allows a fund to borrow amounts equaling up to 50% of its net assets. Prior to the Proposing Release, the SEC staff had taken the view that derivatives should not even be considered senior securities if funds had adequate assets or reserves to meet their obligations under the derivatives contracts. The Proposing Release turns that on its head, and states that not only do open derivatives positions—even when covered by adequate reserves—constitute senior securities, they are tantamount to borrowings regardless of the effect on leverage in a fund's portfolio and should be treated as such.

Do the Potential Burdens of Using Notional Amounts Outweigh the Benefits?

The Proposing Release states that the benefits of using notional amounts are that they are easy to determine and generally serve as a measure of a fund's exposure to underlying reference assets. This would allow smaller, "plain vanilla" fund complexes to adhere to the proposed rule. In addition to the legal arguments, the SEC also goes to great lengths to justify the 150% notional limit on a cost-benefit basis through an extensive economic analysis.

The Proposing Release states that, based on its economic analysis, approximately 32% of all funds utilize derivatives and therefore would be impacted by the proposed rule. The SEC estimates that approximately 4% of all funds (and 27% of all alternative funds), 479 in total, would fail the 150% notional limit, and therefore seek to rely on the risk-based limit instead. For reasons discussed in more detail below, we do not believe that funds that fail the exposure-based limit are likely to find any relief in the risk-based limit. Even if one were to assume that the economic analysis is accurate, it would still appear to be unprecedented for the SEC to justify a rule by saying that only 27% of an industry segment will be adversely affected. Presumably the SEC believes that 27% is a low number, essentially incidental to the broader regulatory goals of the proposal. It is not patently obvious to us that 27% is a low number, nor does the record demonstrate that alternatives to an exposure limit based on notional amounts that might affect fewer funds were considered carefully.

Furthermore, there would appear to be two additional burdens that have not been addressed in detail, but should be, given that the proposed test effectively puts some funds out of business. First, what about the financial commitment made by sponsors of those funds in creating such products? Has the cost of shutting down those funds, including the lost investment in starting those funds, been fully considered? What about the expectations of the investors in those funds, who presumably sought particular strategies and who also might reasonably have expected to benefit from the protections of the 1940 Act? Second, has the burden on future product development and the impact on the U.S. advisory business been fully contemplated? By pushing products outside the 1940 Act and potentially to the more favorable regulatory regime in Europe (not a phrase one hears very often), it is not inconceivable that future development, investment and talent will migrate away from U.S. registered fund products. Again, it is not clear that the record demonstrates that the SEC considered alternatives that would not have these effects on U.S. sponsors and investors.

"By pushing products outside the 1940 Act . . . it is not inconceivable that future development, investment and talent will migrate away from U.S. registered fund products."

Risk-Based Limit

The proposed risk-based limit would allow a fund to have aggregate exposure of up to 300% of its net assets, so long as the fund's derivatives positions reduce the fund's overall "value-at-risk" ("VaR"). Generally speaking, VaR is a method of estimating potential loss. In order to rely on the risk-based limit, the VaR of a fund's entire portfolio (including derivatives) must be less than the VaR of the fund's non-derivatives holdings. This effectively reserves the risk-based limit for funds that use derivatives almost exclusively for hedging purposes to reduce risk, and is therefore unlikely to be available to alternative funds. Furthermore, the limit as proposed is designed to apply only to funds that have *securities positions* that are hedged by derivatives to reduce risk. There are many funds designed to hedge risk vis-à-vis broad market measures but that do not have substantial securities holdings, as they primarily use derivatives, backed by cash and cash equivalents, to achieve that hedged exposure. Because the proposed limit requires that derivatives reduce the VaR of a fund compared to the VaR of the *securities* held by the fund, many funds that pursue objectives of reducing risk compared to equity markets will be precluded from using the risk-based limit.

Asset Segregation Requirements

In order to rely on Rule 18f-4 to engage in derivatives and financial commitment transactions, funds must comply with new asset segregation requirements in addition to the portfolio limitations discussed above. The proposed rule requires that funds segregate "qualifying coverage assets," which involves different requirements for derivatives and financial commitment transactions.

With respect to derivatives transactions, funds would need to maintain assets on a daily basis with a value equal to the mark-to-market value on that day, plus an additional "risk-based coverage amount" that reflects an estimate of any additional amount the fund might owe if it were to exit the transaction under stressed conditions. Funds could not "net" derivatives positions unless such positions are subject to a netting agreement, but would be allowed to consider margin that had been posted as counting toward its qualifying coverage amount.

With respect to financial commitment transactions, funds would need to maintain qualifying coverage assets equal to the amount of the obligations under such transactions, whether conditional or unconditional. The mark-to-market approach would not be available with respect to financial commitment transactions.

As proposed, the rule only allows cash and cash equivalents to count toward a fund's qualifying coverage assets (compared to existing SEC staff guidance that permits the use of any liquid securities). If a fund is obligated to deliver a particular asset pursuant to a derivative or financial commitment transaction, a fund can also count that asset toward its qualifying coverage assets. The proposed asset coverage requirements, by focusing on mark-to-market measures of exposure, are in many ways more realistic than current requirements, although current requirements are not necessarily clear or uniformly applied. The requirement for a risk-based buffer is also unlikely to draw significant comment other than with respect to a board's role in evaluating the buffer, and it is helpful that the level of required buffers was not prescribed in the rule and treated in a "one-size-fits-all" manner. We expect comment, however, on the limitation of assets that can be used for segregation to cash and cash equivalents, which could lead to drags on performance. In many regulatory regimes, including for other U.S. securities law purposes, "haircuts" are used to give credit towards collateral requirements for different types of instruments (e.g., cash is treated as 100 cents on the dollar but equities are treated as 50 cents on the dollar), and we expect that commenters will at a minimum suggest similar adjustments to the current proposal. We also note that the treatment of unfunded capital commitments under the asset segregation limits may have significant effects on certain types of products. For example, funds of private equity funds may choose to avoid primary commitments to underlying funds to avoid having to maintain the entire capital commitment in cash, if the rule is adopted as proposed.

Derivatives Risk Management Program Requirements

If a fund has more than 50% notional exposure to derivatives transactions, or engages in any "complex derivatives transactions,"[3] it would be required to adopt a tailored derivatives risk management program. A fund would be required to adopt certain policies and procedures reasonably designed to assess and manage the fund's derivatives transactions, and to ensure appropriate asset segregation. Additionally, a "derivatives risk manager" must be designated to administer the program. The SEC estimates that approximately 52% of alternative funds would be required to implement a derivatives risk management program.

The requirement for a derivatives risk manager is characteristic of recent SEC rulemaking initiatives, reflecting a trend towards what has been called "prudential oversight." One could imagine several approaches to potential rulemaking in this area. The SEC could craft intricate rules that prescribe and proscribe certain behaviors, such as the money market fund rule. An alternative would be to permit funds some flexibility, but to place burdens on fund boards to serve as checks on conflicts of interest that may arise, such as the SEC's rule with respect to affiliated brokerage. Still another approach would be prudential oversight, tasking individuals with overseeing risk and reporting on such risk, including to the regulator. In proposing Rule 18f-4, the SEC has decided to employ all three approaches simultaneously.

Significant Industry Response Expected

The new proposed rule would have far-reaching effects on the fund industry. If adopted as proposed, the management of many products, especially alternative funds, would be affected. Some funds would need to become commodity pools or private funds or move offshore and certain types of strategies may migrate to non-1940 Act products such as structured notes. As noted, we expect that the SEC will receive a significant amount of comment from the industry and other interested parties on proposed Rule 18f-4, including from Simpson Thacher. We will be monitoring comments and other developments regarding this rule proposal carefully, and intend to address them further in future Alerts.

3. The Proposing Release defines a "complex derivatives transaction" as any derivatives transaction for which the amount payable by either party upon settlement date, maturity or exercise: (i) is dependent on the value of the underlying reference asset at multiple points in time during the term of the transaction; or (ii) is a non-linear function of the value of the underlying reference asset, other than due to optionality arising from a single strike price.

Industry Advocates For Alternative Approach to Liquidity Management; Questions Whether Swing Pricing Is Feasible

As discussed in our last Alert, the SEC recently proposed new Rule 22e-4, which would require open-end funds and ETFs (other than money market funds) to adopt liquidity management programs. Separately, the SEC also proposed revisions to Rule 22c-1 to permit open-end funds (other than money market funds and ETFs) to implement "swing pricing," which would allow a fund the option to adjust the net asset value applicable to purchasing or redeeming shareholders to pass along expenses associated with their trading activity. The SEC received more than 75 comment letters on the proposed rules, including a letter from Simpson Thacher. This Alert summarizes notable themes presented in comments from industry participants.

General Comments

Many industry commenters expressed support for the SEC as the appropriate regulator to address this issue (as opposed to the FSOC or another member of FSOC). The Investment Company Institute ("ICI") and a number of other commenters stressed that open-end funds have successfully and consistently managed liquidity for over 75 years. While commenters acknowledged that there have been a few exceptions to the industry's otherwise sterling reputation in this regard, there has been no indication that open-end fund liquidity poses systemic risks to the U.S. financial system, even during periods of significant market stress.

A major theme of comment letters was that the proposed liquidity requirements were overly rigid, expensive and prescriptive. The historical ability of funds to meet liquidity needs caused the ICI and others to question the SEC's basis for proposing such prescriptive requirements. Several commenters expressing views on behalf of independent board members echoed this sentiment, and noted that such an approach fails to recognize that investors know that liquidity considerations can impact the value of their investment. A letter from the chair of the independent trustees of the Fidelity Fixed Income and Asset Allocation Funds noted that the goal of liquidity management should be to ensure daily liquidity—not to eliminate liquidity risk. An editorial in the *Wall Street Journal* recently made a similar point.

As an alternative, commenters urged the SEC to consider a more risk-oriented, principles-based approach akin to the compliance rule (Rule 38a-1). They argued that this approach, which would require funds to adopt written liquidity management policies and procedures, would allow funds to develop more flexible programs designed to address individual fund needs (subject to board oversight).

While commenters did not appear to oppose universally the reporting of position-level liquidity assessments to the SEC, they generally pushed back against the idea of disclosing such information to the public. Many commenters emphasized that liquidity determinations are inherently subjective, suggesting that there should be a safe harbor from liability for reasonable determinations and expressing concern that liquidity determinations lack the degree of confidence that usually attaches to data that is reported (and certified) in regulatory filings. As another argument against public disclosure, some commenters pointed out that liquidity information could be deemed to be proprietary or competitively sensitive.

Liquidity Categories

One of the SEC's main proposals would require funds to assess whether each portfolio position (or part of a position) would fall into one of six liquidity categories, based primarily on the expected number of days it would take to convert that position into cash at a price that does not materially impact its value. With respect to the SEC's proposed liquidity categories, commenters suggested a variety of alternative approaches (e.g., the ICI suggested three categories, the Asset Management Group of the Securities Industry and Financial Markets Association ("SIFMA AMG") suggested four categories and JPMorgan Asset Management ("JPMorgan") suggested five categories). Critiques of the SEC's proposed categories were often based on the notion that the SEC's categories and methodology assume a level of precision and certainty in liquidity determinations that is not realistically possible—especially with respect to determining whether selling a position would materially impact its value. Echoing this sentiment, commenters such as Wells Fargo Asset Management emphasized that liquidity determinations are not an exact science, and JPMorgan asked the SEC to consider listing liquidity factors as guidance in the adopting release, as opposed to the text of the new rule, because the proposed factors may not apply to all funds/instruments. Several commenters suggested that liquidity categories should be based on relative liquidity, as opposed to absolute liquidity, to reflect more accurately how funds generally treat different types of assets. The ICI and Invesco also pointed to another potentially flawed assumption underpinning the SEC's proposals—that portfolio managers will sell their most liquid assets first in order to meet redemptions. They noted that portfolio managers often take a different approach, such as selling a representative slice of a fund's overall portfolio in order to maintain the fund's existing investment allocations. The ICI and OppenheimerFunds also expressed the view that fund advisers are unlikely to replace their existing methodologies with the new classifications, meaning the SEC's categories would become merely "a prescriptive regulatory requirement that exists alongside industry best practices."

Notably, several commenters, including the Mutual Fund Directors Forum, voiced concern that certain aspects of the SEC's proposal might increase systemic risk. For example, the proposing release expects that funds will look to vendors to aid in determining the liquidity of individual positions, but that practice could create systemic risk by concentrating judgment in a small number of vendors. Commenters such as T. Rowe Price also raised questions about whether the proposed regime might create a perverse illusion that allows funds that push the envelope, by assigning a more-liquid category to portfolio positions, to appear to be more liquid (and therefore less risky) than funds that choose to be more conservative in their liquidity determinations.

Three-Day Liquid Asset Minimum

A second key aspect of the SEC's proposal was that funds be required to maintain a minimum amount of "three-day liquid assets," with such amount to be approved by the fund's board. This would require funds to maintain a minimum amount of assets in the two most-liquid categories proposed by the SEC. If a fund fell below the minimum, it would be prohibited from investing in assets that fall within lower-liquidity categories until the fund's portfolio resumes compliance with the minimum.

Commenters expressed significant opposition to the SEC imposing such a minimum, often citing it as a "one-size-fits-all" approach representing regulatory overreach by the SEC.[4] They expressed concern that the minimum requirement could unduly restrict portfolio management operations for funds, forcing them to deviate from their stated investment strategies. For example, the Independent Directors Council noted that a fund that seeks to maintain weightings in certain sectors, countries, securities or

4. The regulatory authority for the SEC to adopt the three-day minimum was not directly challenged by any commenter, although three comment letters (ICI, SIFMA AMG and Invesco) cited to our prior Alert questioning the SEC's authority to adopt a three-day minimum.

other asset types could be restricted in its ability to pursue that strategy any time it fell below the three-day liquid asset minimum.

Several commenters also argued that the proposed minimum could create an effect akin to cash drag on fund performance, and that the board approval requirement would limit the flexibility of portfolio managers to adapt to rapidly changing market conditions and fund flows. Alternative suggestions included setting a liquidity range or a liquidity target, without the prohibition on investing in less liquid assets if a fund falls below its range/target, or allowing the fund's board to delegate its authority to approve a change in the liquidity minimum to a committee of the adviser's employees.

Closed-End Funds and ETFs

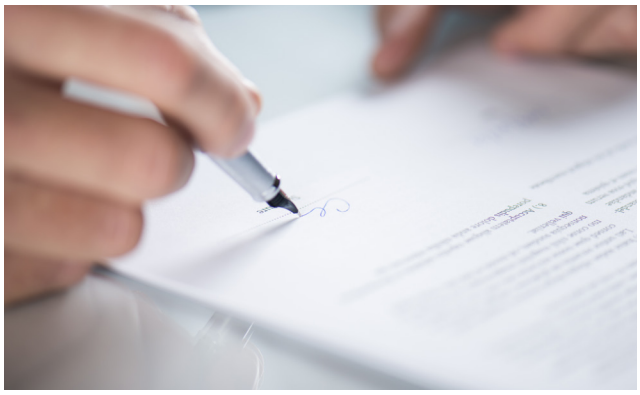
Our comment letter focused on supporting one aspect of the proposed liquidity management rules—that closed-end funds should be excluded from the requirements. As closed-end funds do not issue redeemable securities, they do not need to meet continuous redemptions from the public. Additionally, when Congress enacted the 1940 Act, and Section 22(e)'s requirement to pay redemptions within seven days, the closed-end fund structure had existed for almost 50 years and it was acknowledged that closed-end funds offer investors a vehicle that is designed to make longer-term investments than open-end funds. The SEC acknowledged that it has historically recognized that the liquidity needs of closed-end funds are different from open-end funds, and we offered support for that position. Comment letters from Invesco and State Street Global Advisors urged the SEC to carve ETFs out of the liquidity management requirements, noting that they typically redeem in-kind and, in the case of index funds, may have difficulty maintaining a minimum amount of liquid assets while seeking to track an index.

Swing Pricing

Commenters expressed a variety of opinions regarding whether swing pricing should be permitted and what types of costs should be passed on to transacting shareholders. A common thread in comments on all sides of these issues, however, was that there are significant operational differences between the United States and jurisdictions that currently utilize swing pricing, and it would be nearly impossible for U.S. funds to implement swing pricing without significant systemic changes. For example, the ICI and several commenters who currently manage European UCITS funds pointed out that European funds have several hours after the market closes to receive and process flow information from intermediaries (such as omnibus accounts) prior to the deadline for finalizing a fund's net asset value. U.S. funds generally publish their net asset value prior to receipt of flow information from intermediaries. Commenters generally requested that the SEC consider these operational impediments and provide more nuanced guidance in any adopting release.

SEC Staff Issues Distribution in Guise Guidance; Raises Questions Regarding Responsibilities of Advisers and Boards

Following a much publicized industry-wide "sweep exam" in early 2014 focused on mutual fund arrangements with financial intermediaries (as discussed in our prior Alert), the staff of the SEC's Division of Investment Management ("Staff") issued a guidance update in January 2016 addressing issues uncovered by the Staff during the sweep exam ("Guidance Update"). The Guidance Update updates and provides additional gloss on earlier Staff guidance in this area, promulgated primarily through the so-called "supermarket" letters from the late 1990s.[5]



At issue in the sweep exam, a subsequent enforcement action and the Guidance Update are mutual fund arrangements with financial intermediaries that allow fund shareholders to invest indirectly through an omnibus platform (instead of directly with the fund). "Direct" shareholders of a fund receive certain services from the fund's transfer agent, such as account statements and tax documentation.

5. *See, e.g.*, Investment Company Institute, SEC No-Action Letter (Oct. 30, 1998).

"Indirect" fund shareholders typically receive such services from their intermediary ("sub-TA services"). In addition to providing sub-TA services to indirect fund shareholders, many intermediaries also offer marketing/distribution support (such as "shelf space," preferred lists or direct marketing of particular funds) for the funds on their platform.

While a fund is permitted to pay for sub-TA services, Section 12 and Rule 12b-1 under the 1940 Act prohibit a fund from "financing any activity which is *primarily intended* to result in the sale of shares" of the fund, other than through payments made pursuant to a 12b-1 plan (emphasis added). A Rule 12b-1 plan is a written plan, approved by a fund's board of directors, stipulating that fund assets, up to a certain amount (typically up to 25 basis points for so-called Class A shares), may be used to pay for marketing or distribution of fund shares. To the extent that a financial intermediary charges fees for marketing/distribution that exceed a fund's Rule 12b-1 plan, the fund's adviser must pay the excess out of its legitimate advisory profits. In intermediary arrangements involving the bundling of sub-TA services and marketing/distribution services, a fund's adviser is tasked, with board approval, with appropriately allocating payments among each category of services. If no part of the bundled fees is paid primarily to compensate the intermediary for marketing/distribution, then allocation typically is not required.

> *"The Staff positions stated in the Guidance Update raise questions of whether advisers and boards need to revisit existing practices . . ."*

The Guidance Update places heavy emphasis on the duties of advisers to provide, and mutual fund boards to review, adequate information regarding payments made to financial intermediaries. The Staff positions stated in the Guidance Update raise questions of whether advisers and boards need to revisit existing practices with respect to the approval, renewal and oversight of Rule 12b-1 plans.

The Guidance Update states that mutual fund boards need to implement a process that is reasonably designed to evaluate whether a portion of any fees paid for sub-TA services is being used for marketing/distribution. In discussing that process, the Staff reiterated several factors outlined in the supermarket letters and also included certain additional factors beyond the existing guidance. The latter category includes, among other things:

- How sub-TA fee levels may impact other payment flows (such as 12b-1 fees and revenue sharing payments made by the adviser to intermediaries);
- Intermediaries' use of fees received from a fund for sub-TA services;
- Specific sub-TA services provided to the fund by each intermediary;
- Whether any sub-TA services provided could have direct or indirect distribution benefits;
- Payments received by each intermediary for sub-TA services and other payment flows made to support marketing/distribution for the fund;
- The extent to which payments for sub-TA services may reduce or otherwise impact (i) the expense burden on the fund's adviser (or its affiliates) and (ii) the level of fees paid under the fund's Rule 12b-1 plan;
- Which employees of the adviser or intermediaries negotiate the fees to be paid for sub-TA services, whether the primary job of such employees is to distribute the fund and the process for approval of fees for sub-TA services; and
- A comparison of fees paid for sub-TA services among all intermediaries and, if applicable, a comparison of the sub-TA services provided.

Further, the Guidance Update discusses how intermediaries should provide sufficient information to fund boards to enable them to evaluate whether any fund assets are being used for marketing/distribution outside of a Rule 12b-1 plan. These references suggest that a board (and independent board counsel) may wish to consider sending information request letters directly to intermediaries, or request that advisers obtain this information in writing in order to support the board's determinations on these issues.

The Guidance Update also states that many mutual funds do not appear to have policies and procedures that specifically address compliance with Section 12 and Rule 12b-1. The Staff notes that such policies and procedures should be in place regardless of whether a fund has adopted a Rule 12b-1 plan, as the prohibitions in the statute and the rule would still apply to the fund.

The Guidance Update is notable for several reasons. First, the guidance applies (as does existing guidance prior to the update) only to the purchasers of services, and not the providers (i.e., the financial intermediaries). Without a concomitant obligation

on the part of financial intermediaries to provide information that is requested, funds and their boards may remain in the awkward position of having to make judgments with incomplete information. Second, the Staff seems to imply that open-end funds have an effective ban on use of fund assets to pay for distribution even incidentally, essentially reading the words emphasized above ("primarily intended" for distribution) out of the statute. One could imagine intermediary arrangements that are clearly not primarily intended to further distribution that may nonetheless have some distribution component. The Guidance Update does not seem to account for that possibility. Finally, the Staff criticizes a common allocation method in the industry—paying intermediaries out of Rule 12b-1 fees first, then sub-accounting (out of fund assets) and then revenue share—as rife with conflicts of interest. Many industry participants use the current allocation method, and it is well-settled that Rule 12b-1 fees may be used for purposes that are not solely related to distribution. The "tiered payment structure"

called into question by the Staff is in most cases, in our experience, reasonable and defensible, since Rule 12b-1 plans and payments out of the adviser's legitimate advisory profits both cover payments that could be said to be primarily intended to result in the sale of fund shares. Where a distribution plan has been adopted and disclosed, to suggest that a presumption that such plan will be used to actually make distribution payments is invalid is to call into question Rule 12b-1 plans altogether. While the SEC may choose to, and has indeed chosen to in several notable efforts in the past, cast doubt on the current distribution framework used in the industry, we would have thought that the appropriate method for doing so would be to revise its existing rule, instead of questioning well-settled practices in a guidance update not subject to notice and comment.

Three-Way Proxy Battle for Control of a BDC Ends in Apparent Stalemate

Over the past six months, a contentious three-way contest for control of a publicly traded business development company has been unfolding through proxy materials, the press and in court. The situation is noteworthy not only for the salacious accusations and colorful language that has been bandied about by the parties, of which there have been plenty, but also because of the novel strategies they have employed and the unusually complex set of alternatives that have been presented to shareholders as a result.

The conflict began in August 2015, when the board of TICC Capital Corp. ("BDC"), announced that BDC's Adviser, TICC Management LLC ("TICC Adviser"), had entered into an agreement to sell itself to Benefit Street Partners L.L.C. ("BSP") for an undisclosed price. As the proposed transaction would have resulted in a change of control of the TICC Adviser, which in turn would automatically terminate the BDC's current advisory agreement, the sale was conditioned on the BDC's shareholders approving a new advisory agreement to allow BSP to manage the BDC's investments after the sale. Towards that end, the BDC's board formed a special committee that negotiated, presented and endorsed a proposed advisory agreement with BSP, stating that the deal would be in the best interest of BDC shareholders. Such changes of control are common in the industry, and the vast majority of such transactions are approved by shareholders with little fanfare. In this case, however, the proposed BSP agreement was not well received by certain investors.

In particular, the BDC's largest shareholder, Raging Capital Management LLC ("Raging Capital"), publicly disclosed a letter it penned to the BDC's board requesting that the board acknowledge "serious shareholder concerns" by engaging an independent investment bank to evaluate all of the options for the BDC's future, stating that such a review would ensure the board was not "rubber stamping" a deal that would disproportionately benefit existing TICC management (and specifically the three principals of TICC Adviser) at the expense of BDC shareholders.

Within a week of the BSP agreement being publicly announced, NexPoint Advisors, L.P. ("NexPoint") approached the BDC's board with an alternate proposal to manage the BDC that expressly maintained the BDC's investment strategy while offering a lower fee than the proposed agreement with BSP. The BDC's board rejected NexPoint's

private proposal quickly. Less than a week after their offer was rejected, NexPoint published its alternative proposal publicly and alleged that the BDC board's rejection of the offer was not preceded by serious negotiation or consideration, and amounted to dereliction of the Board's duties owed to shareholders.

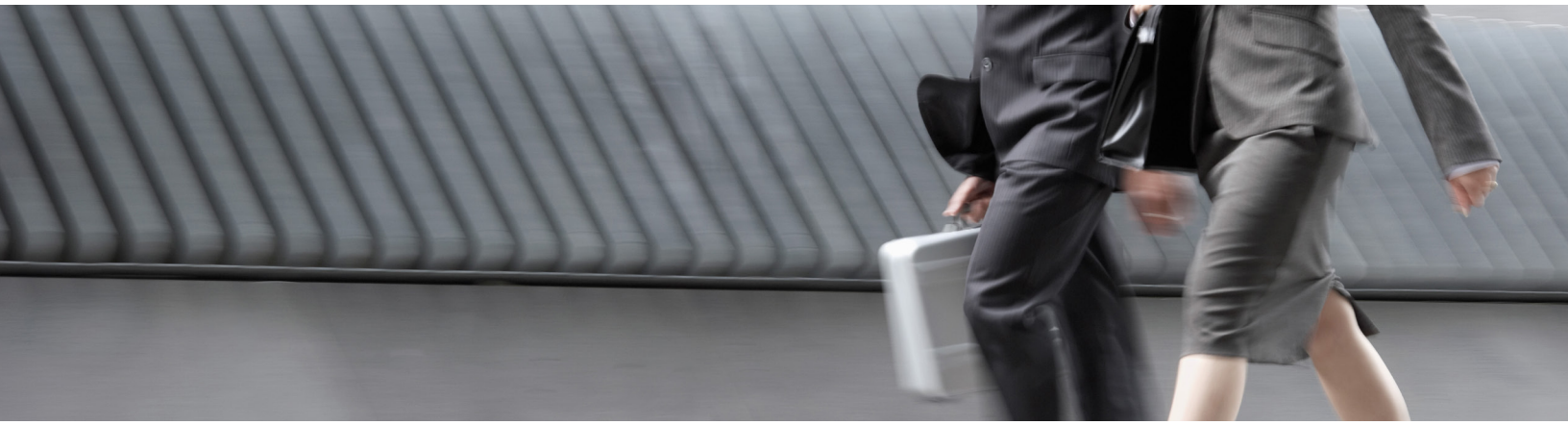
On September 3, 2015, two weeks after NexPoint publicly disclosed its rejected alternate offer and made the related accusations, the BDC's board formally announced that it had rejected NexPoint's proposal because, in the board's view, the arrangement with BSP was comparatively advantageous due to BSP's superior resources in origination and portfolio management. Notably, the board also announced a revised BSP agreement that featured a reduction in the annual base management fee from 2.00% to 1.50% of gross assets.

On September 10, a third player, TPG Specialty Lending ("TSLX"), a business development company, offered to acquire the entire BDC in a stock-for-stock transaction, valued at a premium based on then-current share prices. After its initial offer to the BDC's board was also rejected, TSLX made a public stock-for-stock offer to the BDC's shareholders and similarly alleged that its private overtures to the BDC's board were met only with cursory responses and nominal requests for information before the BDC's board decided to end negotiations. TSLX's public bid for control proposed that TSLX would remove the TICC Adviser if successful. The BDC's board brushed aside the accusations that it did not review the proposal on its merits, arguing that it rejected TSLX's offer because the share price premium was illusory, given it would be non-cash consideration in the form of TSLX shares whose value could change, and that TSLX's offer actually represented a discount to the BDC's then most recently reported net asset value.

After rejecting the NexPoint and TSLX offers, the BDC's board attempted to move forward with the BSP agreement by filing a proxy statement calling for a special meeting to approve the proposed advisory agreement. In response, TSLX filed competing proxy solicitation materials in an attempt to buy the BDC in opposition to management's proposal. Meanwhile, NexPoint filed a third set of proxy materials nominating a competing slate of six director candidates to give shareholders a direct route to approve its alternate proposal without NexPoint having to negotiate with the BDC's existing board.

NexPoint's strategy of attempting to seize control of the BDC's board at the special meeting to vote on the BSP advisory contract was met with resistance. In early October, the BDC's board took the position that NexPoint's proposed slate of nominees would not be considered a valid item of business at the special meeting and refused to add NexPoint's nominees to the ballot, prompting NexPoint to initiate litigation. NexPoint initially received a temporary restraining order requiring the BDC's board to allow NexPoint's directors to appear on the ballot, but in late October, a federal district court judge sided with the BDC's board and held that NexPoint's nominees were invalid because any expansion or restructuring of the board to be voted on at the special meeting was conditioned on the advisory contract with BSP first receiving approval.

The district court judge was, however, persuaded that the BDC's board made material omissions and misleading statements in its communications to shareholders, including finding that the BDC's board failed to disclose the extent to which certain key individuals would benefit from the proposed BSP



transaction. The judge also noted that the BDC's board misled investors by implying that the law firm it had retained as special counsel and the investment bank it had retained had advised the board when it rejected NexPoint's proposals, when they were in fact only retained to advise the BDC's board after it had rejected the offer.

Following the district court's first decision to allow the shareholder vote to take place without NexPoint's slate of directors, the BDC's board attempted to make the required disclosures and revisions to its proxy materials, but did so concurrently with an announcement that it had reached an agreement with the BDC's largest shareholder, Raging Capital, to secure Raging Capital's support for the BSP agreement. Under that agreement, Raging Capital agreed to vote all of its shares in favor of approving the BSP advisory contract in exchange for Raging Capital receiving the right to appoint an independent director to the BDC's Board and BSP agreeing to further discount its base annual management fees by 0.25%, resulting in a base fee of 1.25%, for the first two years of the new contract's term (a decrease from the 2.00% fee contemplated in the original agreement the BDC's board reached with BSP in August). TSLX increased its bid price by approximately 3.00% in response to this development.

NexPoint continued to press on in the courts with some success. NexPoint successfully argued that the BDC board's revised disclosures were still inadequate and, in the end, the judge penned the disclosure himself. The language of the final disclosure was unsparing, and included specific mention that the BDC's board had failed, twice, to adequately disclose that certain key individuals stood to gain up to $10 million in a cash distribution and that they would own 24.9% of the new adviser. The district court judge did not, however, reverse his decision that the shareholder meeting could proceed without NexPoint's slate of directors. NexPoint then turned to the Second Circuit Court of Appeals for relief, but, on December 9, 2015, the appellate court refused to delay the repeatedly rescheduled shareholder meeting any further. Though its decision did not reach the merits as to whether NexPoint's directors would have been valid or invalid, the appellate court noted that it viewed efforts to continue to block the proxy vote from occurring as a bigger threat to shareholder democracy than the alleged misconduct of the BDC's board in keeping the NexPoint directors off of the ballot.

Free from the threat of further injunctions on that front, the BDC's board pushed forward with its plan for a special shareholder meeting, setting a date of December 22, 2015 for the vote. In an effort to further appease critics of the BSP agreement, the BDC conducted a share buyback program and repurchased more than $20 million worth of shares in the weeks leading up to the vote. The BDC's board began using the argument that a "no" vote would not result in a positive change for the BDC, because failure to approve the BSP advisory agreement would result in the BDC implementing a new investment strategy without the resources of BSP.

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The BDC's board's actions were not enough to convince shareholders, however, and the BSP agreement was rejected by shareholders. Despite soliciting votes since August, the BSP agreement reportedly only received the support of 36% of outstanding shares. Both NexPoint and TSLX were quick to praise the result and did not mince their words. "We believe TICC's stockholders recognized the repeated, in our view, egregious misconduct of the Board in attempting to implement a windfall insider transaction through deception and specious assessment of our superior management proposals," said a NexPoint representative. TSLX's management stated that, "TICC stockholders are demanding real change in the management and governance of TICC. If the TICC Board of Directors is unwilling to fulfill its fiduciary duty and move swiftly to engage with us . . . . TICC stockholders have other viable avenues for change, including taking direct action to terminate the existing investment advisory agreement . . . ."

In sum, the months of competition between BSP, NexPoint and TSLX thus far has resulted in the TICC Adviser retaining control of the BDC's activities. Both NexPoint and TSLX have expressed their continued interest in the BDC, while BSP's statement expressed only disappointment in the result of the shareholder vote. It is not immediately clear what the future holds for TICC and whether the situation is *sui generis* or is a bellwether for increased activism in the business development company universe.

OCIE Announces 2016 Examination Priorities; Builds Upon Past Initiatives

In its Examination Priorities for 2016, the SEC's Office of Compliance, Inspections and Examinations ("OCIE") organized its priorities within the same three "thematic areas" as its 2015 Priorities. As discussed in a prior Alert, these three thematic areas are: (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 and registered advisers:

- In connection with its multi-year examination initiative launched in June 2015, ReTIRE, OCIE will focus on registered advisers and broker-dealers that offer services or products to investors with retirement accounts. Specifically, OCIE will look at the suitability of recommendations made to such investors, conflicts of interest, supervision and compliance controls and marketing and disclosure practices.
- With respect to ETFs, OCIE will examine for compliance with granted exemptive relief and other regulatory requirements and will review ETFs' unit creation and redemption processes. OCIE will focus on, among other things, sales strategies, trading practices and disclosures involving ETFs, with specific emphasis on niche and leveraged/inverse ETFs.
- OCIE will continue to examine advisers that offer retail investors a variety of fee arrangements, with emphasis on whether account type recommendations are in the best interest of the retail investor at the inception of the arrangement and thereafter.
- OCIE will also continue focusing on cybersecurity compliance and controls in its examinations of advisers, and will expand its examination efforts to include testing and assessments of firms' implementation of procedures and controls.
- Noting the recent hikes in interest rates and other changes in the fixed-income markets, OCIE will prioritize examinations of advisers to funds that have exposure to potentially illiquid fixed-income securities. Such examinations will include, among other things, a review of controls over market risk management, valuations, liquidity managements and trading activity.
- OCIE will continue its "Never-Before-Examined Registered Investment Company Initiative," which is intended to conduct focused, risk-based examinations of advisers and investment companies that have never been examined.

As many of OCIE's priorities echo its 2015 (and earlier) priorities, we expect OCIE to dig deeper on these topics during 2016 examinations. For example, OCIE began a second round of cybersecurity sweep examinations in late 2015. We are aware that many of the firms that were examined in the first cybersecurity sweep have reported that OCIE is asking for much more nuanced and in-depth information from affiliates who are being examined in the second sweep.

4th Quarter 2015 Notable Transactions

M&A Transactions:

- **London Stock Exchange Group plc** announced that it approved the proposed sale of Frank Russell Company's asset management business, **Russell Investments**, to **TA Associates**. The gross proceeds earned from the transaction by the London Stock Exchange Group plc will equal $1.15 billion, with $1 billion payable in cash upon completion, and the remaining $150 million paid in four equal cash installments starting on December 31, 2017.

- **Segall Bryant & Hamill**, an investment management firm with $9.7 billion in assets under management, announced its acquisition of **Trees Investment Counsel, LLC**, which provides investment counseling and management services for affluent investors, families and trusts and estates. SBH's Private Wealth Management team currently manages over $3 billion in assets.

- **Edelman Financial Services LLC** announced that it entered into a definitive agreement to be acquired by certain affiliates of **Hellman & Friedman LLC**, a private equity firm that has raised over $35 billion of capital since its founding in 1984. Edelman provides financial planning, investment management, 401(k) plan services to individuals, families and businesses and currently manages over $15 billion in assets.

- **NorthStar Asset Management Group Inc.**, a global asset management firm focused on managing real estate and other investment platforms both in the United States and internationally, announced that it entered into a definitive agreement to acquire an approximately 85% interest in **The Townsend Group**, which provides investment management and advisory services to approximately $180 billion of assets, with a focus on real estate. Subject to the terms and conditions of the purchase agreement, NorthStar will acquire the interest in Townsend for approximately $380 million.

- **WisdomTree Investments, Inc.** announced it entered into an agreement to acquire **GreenHaven Commodity Services, LLC**, which is the managing owner of the GreenHaven Continuous Commodity Index Fund, and GreenHaven Coal Services, LLC, the sponsor of the GreenHaven Coal Fund. Wisdom Tree is an exchange-traded fund and exchange-traded product sponsor and asset manager headquartered in New York. It will acquire GH Commodity and GH Coal for $11.75 million in cash consideration.

- **MB Financial Bank, N.A.**, a commercial bank based in Chicago with approximately $15 billion in assets, entered into an agreement to acquire **MSA Holdings, LLC** and its wholly-owned subsidiaries **MainStreet Investment Advisors, LLC** and **Cambium Asset Management, LLC**. MainStreet provides investment advisory services for insurance companies, banks and independent trust companies. It also functions as a sub-advisor, providing investment recommendations, research, marketing and investment manager support to its investment manager clients. Cambium provides wealth management services such as separate account management, retirement planning and small account platform services.

- **Affiliated Managers Group Inc.**, a global asset management company with aggregate assets under management of approximately $619 billion agreed to acquire an equity interest in three investment managers: **Ivory Investment Management LP**, **Abax Investments (Pty) Ltd** and **Systematica Investments LP**. Ivory is a Los Angeles-based investment firm, and its aggregate assets under management are approximately $3.6 billion. Abax is a Cape Town-based investment manager specializing in South African equity, fixed income and strategic and tactical asset allocation strategies, and its assets under management are approximately $5.4 billion. Systematica is a technology-driven investment firm with offices in Geneva, London, New York, Singapore and Jersey, and it manages approximately $8.8 billion in assets.

- **BlackRock, Inc.** announced that it will assume $87 billion of assets under management from **Bank of America's Global Capital Management**. The acquisition will increase BlackRock's global cash-management business to approximately $370 billion. The transaction is expected to close in the first half of 2016, and it is subject to the approvals of fund boards, fund shareholders and regulatory agencies. BlackRock, Inc. also, in a separate transaction, agreed to acquire **FutureAdvisor**, a digital wealth management firm with over $600 million in assets under management.

- **Baird** signed an agreement to acquire **Chautauqua Capital Management**, a global investment manager based in Boulder, Colorado that manages growth-oriented international and global equity portfolios for institutional investors. Meanwhile, Baird focuses on wealth management, capital markets, private equity and asset management, with approximately $152 billion in client assets. Chautauqua Capital Management will continue to operate under its name but will join Baird Investment Management, Baird's institutional equity asset management business.

- **Conning Inc.** announced that it agreed to acquire New York-based **Octagon Credit Investors LLC**, a credit investment firm that manages $12.8 billion in assets through its various investment vehicles, which include collateralized loan obligations, bank loans and high yield bonds. Octagon will operate as a subsidiary of Conning Inc. following the closing of the transaction.

- **IG Group Holdings Plc**, a UK based global online trading company with offices across Europe, Africa, Asia-Pacific, the Middle East and the United States, announced that it completed its acquisition of **InvestYourWay Ltd.**, an online investment manager that builds bespoke investment solutions. The acquisition will allow IG Group Holdings Plc to expand its offerings to a wider range of ETF-based portfolios per its partnership with Blackrock.

- **Raymond James Financial, Inc.** entered into a definitive agreement to acquire **Deutsche Asset & Wealth Management's U.S. Private Client Services unit**, which provides financial services to sophisticated and high-net-worth clients and institutional investors in large metropolitan areas. The Private Client Services unit will operate under the Alex Brown, Inc. brand of Raymond James Financial, Inc.

- **AGF Management Limited** acquired a majority of the equity of **FFCM LLC**, a Boston-based ETF advisor and asset management firm that creates, structures, and manages ETFs and is currently co-portfolio advisor of AGF U.S. Sector Class. AGF Limited is an independent investment management firm with over one million investors and approximately $33 billion in total assets under management.

- **American Century Investments** and the Stowers Institute for Medical Research announced that a non-controlling 41 percent economic interest in American Century Investments held by Canadian Imperial Bank of Commerce would be acquired by **Nomura Asset Management**. Nomura will purchase Canadian Imperial Bank of Commerce's shares for approximately $1 billion. CIBC has held a non-controlling equity interest in American Century since August 2011.

- **OppenheimerFunds, Inc.**, a global asset manager with approximately $220 billion in assets under management, finalized its acquisition of 100% of the equity interest in independent institutional investment adviser **VTL Associates, LLC**. The transaction, which was announced in September, expands OppenheimerFunds, Inc.'s client offerings into smart-beta strategies. As of September 2015, VTL managed $1.7 billion for its investors across 8 ETFs and separate accounts.

Closed-End Fund Initial Public Offerings:

RiverNorth Opportunities Fund, Inc. (NYSE: RIV)

- Amount raised: $72.6 million
- Investment Objective/Policies: The Fund's investment objective is total return consisting of capital appreciation and current income. The Fund seeks to achieve its investment objective by pursuing a tactical asset allocation strategy and opportunistically investing under normal circumstances in closed-end funds and exchange-traded funds. Under normal market conditions, the Fund will invest at least 65% of its Managed Assets in closed-end funds and at least 80% of its Managed Assets in Underlying Funds. In selecting closed-end funds, the Subadviser will opportunistically utilize a combination of short-term and longer-term trading strategies to seek to derive value from the discount and premium spreads associated with closed-end funds. The Fund will invest in other Underlying Funds that are not closed-end funds to gain exposure to specific asset classes when the Subadviser believes closed-end fund discount or premium spreads are not attractive or to manage overall closed-end fund exposure in the Fund.
- Managers: ALPS Advisors, Inc. and RiverNorth Capital Management, LLC.
- Book-runners: Wells Fargo Securities, RBC Capital Markets and Stifel.

Nuveen High Income December 2018 Target Term Fund (NYSE: JHA)

- Amount raised: $261 million
- Investment Objectives/Policies: The Fund's investment objectives are to provide a high level of current income and to return $9.86 per share (the original net asset value per common share before deducting offering costs of $0.02 per share) to Common Shareholders on or about December 1, 2018. The Fund's subadviser seeks to identify securities across diverse sectors that are undervalued or mispriced. In seeking to return the target amount of $9.86 per share to investors on or about the Termination Date, the Fund seeks to utilize various portfolio and cash flow management techniques, including setting aside a portion of its net investment income, retaining gains and limiting the longest maturity of any holding to no later than June 1, 2019. As a result, the average maturity of the Fund's holdings is generally expected to shorten as the Fund approaches its Termination Date, which reduces interest rate risk over time.
- Managers: Nuveen Fund Advisors and Nuveen Asset Management.
- Book-runners: Morgan Stanley, Wells Fargo Securities and Nuveen Securities.

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

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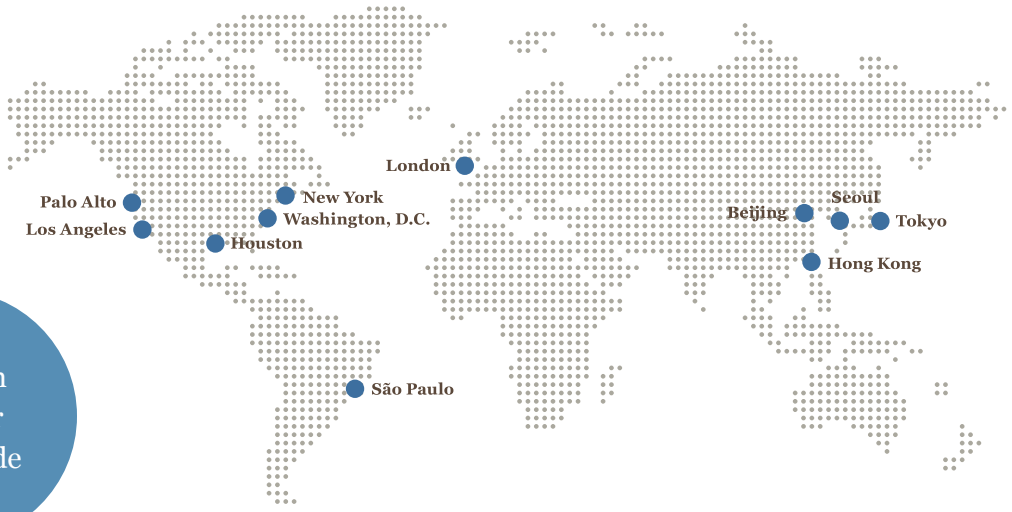

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