Simpson Thacher

Registered Funds Alert

This inaugural edition of the Simpson Thacher Registered Funds Alert discusses recent developments in the registered funds industry, including the latest SEC guidance relating to alternative funds and non-transparent actively managed exchange-traded funds. In addition, it discusses pending SEC enforcement actions that could have an impact on the industry. Finally, we report on notable transactions that occurred in the fourth quarter of 2014, including M&A transactions and closed-end fund initial public offerings.

February 2015

Regulators Indicate Intention to Propose Risk-Based Regulatory Framework Based on Growth of Alternative Funds

Recent statements by regulators, including the SEC and its Staff, indicate a focus on the growth of alternative funds and a potential shift to a more risk-based oversight approach to mutual fund regulation (as opposed to the traditional rules-based model). The SEC's regulatory agenda for 2015 includes its intention to propose rules related to fund liquidity management and use of derivatives. Fund advisers and boards should be prepared for the impact that new SEC rules and potential examination activity by OCIE and FINRA may have on their fund complexes. (click here for full article)

SEC Focusing on Alternative Funds

OCIE is in the process of conducting a national sweep of alternative funds focusing on compliance with regulatory requirements relating to valuation, liquidity and leverage. Recent actions and remarks by the SEC and its Staff also have focused on disclosure and board oversight issues related to alternative funds, among other issues. (click here for full article)

"Distribution in Guise"—Financial Intermediaries' Practices Under Review

The SEC has been conducting examinations regarding payments by mutual funds to financial intermediaries to determine whether such payments constitute "distributions in guise" and would be prohibited under the 1940 Act. Unrelated to those examinations, but with respect to the same underlying activities, the SEC initiated administrative proceedings against the Robare Group alleging violations of Sections 206(1) and 206(2) of the 1940 Act with respect to disclosure of intermediary payments. (click here for full article)

Novel Complaint in Excessive Fee Litigation—"Double-Charging" of Advisory Fees

Plaintiffs in *Curd v. SEI Investment Management Corporation* recently filed an amended complaint that includes a novel allegation that SEI violated its fiduciary duties by not waiving advisory fees charged for investing fund assets in affiliated money market funds resulting in the alleged "double-charging."
(click here for full article)

SEC Guidance and Sweep Examination for Bond Funds

On the heels of a Staff "IM Guidance Update" on fixed-income funds in January 2014, in September 2014, OCIE announced plans to sweep a sampling of fund complexes to review (1) how well prepared bond funds

are for a changing interest rate market and (2) the adequacy of disclosures relating to risks associated with changes in interest rates. (click here for full article)

SEC Weighs in on Non-Transparent Actively Managed ETF Proposals

The ability to offer non-transparent actively managed exchange-traded funds historically has been prohibited by the requirement that such funds disclose their portfolio holdings on a daily basis. However, the SEC recently has considered requests for exemptive relief that would reduce the transparency required for certain actively-managed ETFs. Several applicants have submitted different proposals. The SEC has granted relief to one applicant, but has thus far declined to grant relief to the other applicants. (click here for full article)

4th Quarter 2014 Notable Transactions

List of notable transactions occurring in the fourth quarter of 2014, including M&A transactions and closed-end fund initial public offerings. (click here for full article)

Regulators Indicate Intention to Propose Risk-Based Regulatory Framework Based on Growth of Alternative Funds

Although many in the U.S. registered fund industry might quibble over the definition of what constitutes an "alternative" fund, there is universal agreement that the alternative asset class, however defined, has been a source of significant growth in the industry over the past several years.[1] And not surprisingly, the Securities and Exchange Commission (SEC) has noticed. Recent comments by the SEC Chair and Division of Investment Management senior staff and Office of Compliance, Inspections and Examinations (OCIE) activity suggest that not only is the SEC squarely focused on the growth of alternative funds, but that it is planning on using that growth as a basis for a more risk-based (as opposed to rules-based) approach to mutual fund regulation.

In a recent pair of high profile speeches, Norm Champ, the outgoing Director of the Division of Investment Management, acknowledged the attractiveness of the traditional registered fund wrapper for alternative strategies—both for sponsors and investors—and highlighted certain key risks, most notably liquidity management and derivatives use. Later in this Alert, we discuss in greater detail Mr. Champ's comments regarding alternative funds.

Following Mr. Champ's speeches, the SEC announced its regulatory agenda for 2015, which included its intention to propose rules related to fund liquidity management and use of derivatives. In December, SEC Chair Mary Jo White gave a speech in which she highlighted liquidity management and derivatives use as areas of concern, and framed each issue in the context of systemic risks to the financial system as a whole.

1 For example, under the Wall Street Journal's definition, assets under management in alternative funds have grown 347% since 2008.

Mr. Champ's remarks are notable because he was the first senior official at the SEC to hint broadly that the SEC may be considering risk-based oversight approaches to regulation of registered funds, including with respect to liquidity management and derivatives use. There had been some indication of a general concern regarding liquidity at the Staff level in an IM Guidance Update relating to fixed-income markets published in January 2014, in which the Staff suggested that fund managers may wish to "assess and stress test liquidity" in light of changing fixed income market conditions. In addition to the update and Mr. Champ's remarks, OCIE announced a national sweep of alternative funds in early January 2014. This sweep examination is under way, and has focused heavily on liquidity management, in addition to other issues (also identified in Mr. Champ's speeches). With respect to derivatives, in August 2011, the SEC issued a "concept release" relating to the use of derivatives by registered investment companies. There have been strong indications that derivatives guidance has remained a priority of the Staff since that time, with the delay stemming from a requirement to focus attention on Dodd-Frank related rulemaking, rather than any implication that the concept release and subsequent industry comment obviated the need for further guidance.

Chair White's speech is notable in this context primarily because of the connection she drew between liquidity management and derivatives use, on the one hand, and systemic risk on the other. The Staff has indicated for some time that a new mutual fund data-gathering rule has been a priority of its rule-making group. Chair White reiterated that initiative as well, placing it in the context of alternative funds by saying that current reporting has not "adequately kept pace with emerging products and strategies." Together, the three rule-making initiatives she discussed are reflective of the political realities facing the SEC's continued regulation of the asset management industry. As evidenced by the protracted battle regarding regulation of money market funds, there is significant pressure on the SEC from the Financial Stability Oversight Council (FSOC) to demonstrate that the SEC should remain the primary regulator of the asset management industry and that its historical rules-based approach is adequate to oversee the perceived risks mutual funds may pose to the financial system. Viewed in that light, the SEC's initiatives may be seen as focusing on the types of systemic risk issues that are the primary focus of FSOC and moving towards a prudential regulatory framework more familiar to the other members of FSOC.

The form that these new rules will take is unclear. For example, we would not expect that the SEC will propose the creation of a "chief risk officer" in the same manner in which it required a chief compliance officer in adopting Rule 38a-1. This belief is based on the fact that no uniform definition exists for what a risk officer would do, and partially on the lack of clear statutory authority for the SEC to create such a role, even under the Dodd-Frank Act.

We also do not know the extent to which the new rules will require mutual fund boards to be involved in risk management oversight. Currently, disclosure rules require disclosure of the extent of the board's role in the risk oversight of a fund. Several comments by the Staff and Chair White suggest that a heavier emphasis on the board's substantive role may be forthcoming, although there are many reasons why that would not seem to be an appropriate expectation for fund boards, which are, by design, oversight boards and substantially independent of the day-to-day management of the funds they oversee.

Finally, it would seem to be difficult to propose rules that provide for prudential oversight, as opposed to disclosure or rules-based oversight. Liquidity

rules would be based on the statutory requirement for open-end funds to pay redemption proceeds in seven days found in Section 22(e) of the Investment Company Act of 1940 (1940 Act). Derivatives rules would be based on the prohibitions against issuance of senior securities found in Section 18 of the 1940 Act. Such statutory provisions provide the SEC with the ability to proscribe behaviors, but only to the extent the underlying principles of the 1940 Act are at issue. The SEC has broad power to require disclosure on topics, but that is different from requiring actions beyond the requirements of the 1940 Act. It also is worth mentioning that the SEC would not appear to have the requisite amount of examination staff that would be required to implement a prudential regulatory scheme similar to that used by the Federal Reserve with respect to national banks, for example.

If and when the SEC proposes rules on these topics, we would expect substantial industry comment. Regardless of the form these rules take, fund advisers and boards should continue to think carefully about these issues in the context of their own fund complexes. They should also be prepared for multi-pronged regulatory activity on this front in the meantime, including from FINRA and OCIE.

FINRA's recent release of its Examination Priorities Letter for 2015 also highlighted alternative mutual funds. The release discusses the importance of accurate disclosures regarding how alternative mutual funds work, as well as the importance of maintaining consistency between their prospectuses and communications regarding such funds. FINRA indicated in the release that its review of current practices suggested that investors in such funds might not be able to fully appreciate alternative fund strategies or how such funds will respond in various market situations.

Finally, OCIE recently released its Examination Priorities for 2015. Specifically, the examination priorities release includes "Alternative" investment companies as one of its priorities under its goal of protecting retail investors and those investors saving for retirement. The release indicated a focus on leverage, liquidity and valuation policies and practices and the adequacy of the funds' internal controls, including staffing, funding and empowerment of boards, compliance personnel and back-offices. Similar to FINRA's recent Examination Priorities Letter, OCIE also indicated a focus on the adequacy of current disclosure practices during the marketing period.

SEC Focusing on Alternative Funds

Earlier in this Alert, we discuss recent remarks and actions from the SEC and its Staff that suggest that the growth of alternative funds has been seized upon as a basis for greater risk-based regulation in the registered fund industry. This piece focuses on the compliance and regulatory issues identified by the Staff as relating primarily to "alternative" funds (however defined).

As noted above, in a recent pair of high profile speeches (click here and here for links to the speeches), Norm Champ, the outgoing Director of the SEC's Division of Investment Management, both acknowledged the attractiveness of the traditional registered fund wrapper for alternative strategies—both for sponsors and investors—and highlighted certain key risks.[2] With respect to the attractiveness of the products, Mr. Champ cited investment liquidity, portfolio transparency, lower advisory fees, lower investor minimum requirements and lack of minimum eligibility requirements as key factors that have fueled investor demand compared to similar privately offered funds (to which we would also add simplified tax reporting). But he also cited key compliance risks in managing such products, most notably with respect to the regulatory requirements relating to valuation, liquidity and leverage. He also highlighted certain disclosure and board oversight responsibilities as areas that deserve focus.

Mr. Champ's remarks are notable in several respects, beyond the implications for rule-making discussed earlier in this Alert. First, and most obviously, he highlights areas for heightened attention by sponsors of new and existing alternative funds. Second, he focused his remarks, particularly in his second speech, not just to sponsors of alternative funds but to sub-advisers of alternative funds who may have limited experience in dealing with the rules and regulations applicable to registered investment companies, indicating a potential Staff focus on those firms' involvement in the management of alternative funds.

In addition to Mr. Champ's remarks, OCIE announced a national sweep of alternative funds in early January 2014. This sweep examination is under way, and, unsurprisingly, has focused on many of the same issues identified by Mr. Champ in his speeches.

2 Mr. Champ explicitly excluded closed-end funds and business development companies from his discussion.

Valuation

In fulfilling statutory responsibilities for valuation of securities for which market quotations are not "readily available," Mr. Champ highlighted several key issues for boards of directors and the entities to which they may have delegated day-to-day valuation determinations. In addition to reiterating the need for robust policies and procedures, he suggested that policies should include:

- requirements for monitoring circumstances that may necessitate the use of fair value prices;
- methodologies for determining fair value;
- processes for price overrides;
- assurances that controls are in place to review, monitor and approve all overrides in a timely manner; and
- prompt notification to, and review and approval by, persons not directly involved in portfolio management to mitigate conflicts of interest.

In a sense, these considerations are no different than ones that many fund complexes have already drawn from the recent Morgan Keegan enforcement action against the directors of those funds. The focus on these matters in the alternative fund context, however, is not surprising as many alternative funds use instruments that do not have deep markets or may be bespoke, and in many instances, the portfolio managers will be in the best position to understand the instrument and its proper valuation. Questions posed by OCIE in the sweep examination have similarly focused on many of the issues that arose in Morgan Keegan (for example, by specifically referring to valuation practices for mortgage-backed securities and by asking about the use of indicative broker quotes in valuation). In addition, the OCIE sweep examination has focused on "back-testing" of valuations, indicating a growing expectation that fund complexes will review fair valuation decisions in the context of subsequent market valuations if and when they become readily available, or when the instrument is sold.

Liquidity

Mr. Champ also noted that there was a "close relationship between the liquidity of a portfolio security or asset and the ease with which the security or assets may be valued." In effect, Mr. Champ stated that the Staff would expect that alternative funds that hold a large number of hard-to-value instruments would face issues with respect to regulatory requirements related to liquidity. For open-end

funds, the Staff has typically required that such funds hold no more than 15% of their assets in illiquid securities or assets, defined as an asset that cannot be sold or disposed of in the ordinary course of business within seven days at approximately the value ascribed to it by the fund.

Mr. Champ's comments suggest an increasing expectation on the part of the Staff that compliance programs for registered investment companies and investment advisers will include written policies and procedures with respect to oversight of fund liquidity.[3] Mr. Champ noted several factors to be considered when assessing liquidity, including:

- frequency of trades and quotes for a security;
- number of dealers willing to purchase/sell the security and the number of potential purchasers;
- dealer undertakings to make a market in the security; and
- the nature of the security and the nature of the marketplace in which the security trades.

Questions posed by OCIE in the sweep examination also have focused on the existence of written policies and procedures and whether investment advisers have stress-tested liquidity expectations under different market scenarios. OCIE's questions have also focused on board oversight of such policies and stress-tests, as applicable, including by requesting minutes of board meetings where such topics were discussed.

Leverage

In August 2011, the SEC issued a "concept release" relating to the use of derivatives by registered investment companies. While the SEC and its Staff have not taken any action with respect to the concept

3 Indeed, as discussed above, the SEC, in announcing its 2015 agenda, stated that the adoption of a liquidity management rule would be a priority.

release to date, the release catalogued long-standing guidance by the Staff relating to maintaining "asset coverage" of derivative positions to maintain an adequate limit on leverage and to avoid treatment of the instruments as senior securities under the 1940 Act. Mr. Champ's recent remarks with respect to alternative funds' use of derivatives suggest that the SEC may be looking for boards or investment advisers to take on a more extensive risk management oversight function in connection with the use of derivatives than previously suggested by the SEC or its Staff. OCIE's examination questions in the sweep examination have focused on compliance with the existing guidance, but also have asked for descriptions of limits on "economic leverage," presumably in contrast to "regulatory" leverage. Nonetheless, there appears to be an expectation that alternative funds will be subject to a level of risk oversight not otherwise mandated by prior guidance. While such oversight might be employed by most firms in practice, it remains to be seen whether OCIE will expect some form of formalization of such practices and procedures upon inspection.

During a speech in December 2014, Chair White discussed a set of initiatives, which included a plan to enhance risk monitoring specifically related to the use of derivatives.[4] While the imposition of additional caps on derivative use is unlikely, a rule or guidance might suggest that firms develop policies to assess and manage risk specific to the use of derivatives. Specifically, Chair White indicated that such policies may require a decrease in derivative use during periods of high redemptions. Further, Chair White indicated a need to significantly increase disclosure regarding to fund investments in derivatives.

Disclosure

Mr. Champ also noted several key considerations regarding disclosures for funds which invest in alternative investment strategies. First, he noted that all funds should assess whether current disclosures are in conformity with the plain English standards of the federal securities laws. Secondly, Mr. Champ underscored the Staff's expectation that all disclosures regarding alternative investment strategies be specifically tailored to the particular fund's expected investment strategies and management of those strategies, and noted that the Staff was actively engaged in looking at data regarding fund investments and tying that data back to disclosure. Third, Mr. Champ noted that all such disclosures should reflect the specific fund's "complete risk profile ... taken as a whole," instead of a list of various investment strategies. Specifically, Mr. Champ indicated that alternative funds should include disclosure relating to risks associated with volatility, leverage, liquidity and counterparty creditworthiness. Finally, Mr. Champ suggested that registrants should assess disclosure on an "ongoing basis" to evaluate the completeness and accuracy of disclosures "in light of its actual operations," a suggestion which he reiterated in a speech in October 2014. Our attorneys have publicly taken issue with this statement, advocating that shareholder report disclosure is a more effective tool to educate investors about changes in operations and the associated risks.[5]

Board Oversight

Mutual fund boards traditionally oversee the investment companies' key service providers and those service providers' compliance programs and policies as they relate to the operation of those investment companies. Boards have a statutory obligation to oversee the fair valuation of securities for which there are no readily available market quotations, and in several other aspects are called upon, by statute or rule, to protect fund shareholders in situations where service providers might overreach in navigating conflicts of interests. Mr. Champ, in his speeches, has specifically highlighted board obligations to oversee policies and procedures relating to each of the key risk areas identified by Mr. Champ and discussed above. To the extent that Mr. Champ has indicated the intention of the Staff to expand registrants' obligations with respect to practices discussed above, in the context of alternative funds, one would expect a concomitant increase in the responsibilities of board members to oversee those practices.

Additionally, Mr. Champ also highlighted the importance of board oversight regarding conflicts of interest, particularly with respect to allocation decisions, when the portfolio manager of a strategy also manages a similar strategy in a private fund wrapper. In this regard, Mr. Champ's remarks focused on sub-advisers who were advising registered funds for the first time. In a speech in September 2014, Mr. Champ also warned advisers that were becoming first-time sub-advisers to registered funds "to proceed thoughtfully and cautiously before becoming advisers in registered funds." These remarks, coupled with OCIE requests for findings of material non-compliance by sub-advisers to alternative funds, indicate a particular attention to complexes using third-party sub-advisers as they expand into the alternative fund space.

4 *See also* Andrew Ackerman, *SEC Details Plan to Target Risks at Asset Managers*, The Wall Street Journal, Dec. 11, 2014, *available at* http://www.wsj.com/articles/sec-chief-calls-for-stress-testing-of-mutual-funds-other-asset-managers-1418312083.

5 *See* Peter Ortiz, *SEC, Finra: Liquid Alts Not Always Used as Directed*, IGNITES, Nov. 3, 2014 (quoting Rajib Chanda)

"Distribution in Guise"—Financial Intermediaries' Practices Under Review

As has been widely reported, the Staff has been conducting examinations regarding payments by mutual funds to financial intermediaries. In announcing its review, the Staff referred to the purpose of the examinations as reviewing whether such payments constitute "distribution in guise." If such payments were for distribution, and made out of fund assets and outside of a Rule 12b-1 distribution plan, then the payments would be impermissible under the 1940 Act. These examinations, with respect to mutual fund complexes, have sometimes resulted in follow-up document requests (at times multiple follow-ups) and interviews, but to date have not resulted in any announced referrals to the enforcement division.

The SEC examinations regarding compensation arrangements also have seemed to focus on the intermediaries who receive such payments, and one such intermediary was the subject of a recent enforcement action. While mutual funds have obligations governed by Section 12(b) of the 1940 Act and Rule 12b-1 thereunder, financial intermediaries that are investment advisers have various fiduciary duties with respect to their clients under the Investment Advisers Act of 1940 (Advisers Act), including the duty to act in their clients' best interests. A conflict of interest arises when fee arrangements between investment advisers and mutual fund firms are not adequately disclosed to clients, because the advisers have added incentive to recommend certain mutual funds (from which they will receive compensation) over other funds.

The SEC initiated administrative proceedings against the Robare Group, a Houston-based investment advisory firm (Robare), on September 2, 2014, alleging that Robare violated Sections 206(1) and 206(2) of the Advisers Act, which make it unlawful for any investment adviser to defraud or engage in a practice that would operate as a fraud or deceit upon any client or prospective client. In particular, the SEC has alleged that Robare recommended that clients invest in certain mutual funds while failing to disclose to them a hidden fee arrangement with a broker that compensated Robare for investing client assets in certain mutual funds through the broker's platform.

The order alleged that Robare entered into a compensation agreement with a broker that it did not disclose to its clients. Under the terms of the agreement, the broker would pay Robare between 2 and 12 basis points on the client's investments in no-transaction-fee mutual funds. The SEC alleged that from 2005 through 2013, the advisory firm received approximately $441,000 from the broker pursuant to the compensation agreement.

Robare denied the allegations brought against it and argued in its answer filed September 25, 2014 that it provided adequate disclosure surrounding the fee arrangement with the broker.

If found to have been in violation of federal securities laws, Robare and certain principals face possible disgorgement of profits and civil penalties. The parties were to have filed motions and briefs with the SEC in late January and early February 2015 and hearings will commence in Houston, Texas on February 9, 2015.

Novel Complaint in Excessive Fee Litigation—"Double-Charging" of Advisory Fees

The mutual fund industry has seen a recent spate of claims that investment advisers charged excessive fees by virtue of delegating substantially all of their duties to sub-advisers while retaining much of the advisory fees. Plaintiffs in *Curd v. SEI Investments Management Corporation* recently filed an amended complaint which, in addition to the sub-adviser delegation claim, also includes a novel allegation in the context of excessive fee litigation. The amended complaint alleges that SEI violated the fiduciary duties inherent in Rule 12d1-1[6] of the 1940 Act by investing fund assets in affiliated money market funds and not waiving or reimbursing the fees charged by the money market funds, resulting in "double-charging" of fees.

Accordingly, the complaint alleges that the board violated Section 36(b) of the 1940 Act by failing to conduct a conscientious review of the double-charged fees. Fund managers investing fund assets in money market funds (particularly affiliated money market funds) without waiving or reimbursing the fees charged by such money market funds should consider the potential risk of a similar shareholder derivative claim. In particular, boards should consider whether the fees charged at the investing fund level are for services that are in addition to, rather than duplicative of, services provided to the underlying funds. In addition, boards may wish to consider including disclosure regarding such review in publicly filed documents (such as shareholder reports describing the board considerations in connection with the annual contract renewal process), so that the consideration is available as an argument in a summary judgment motion rather than only available in proceedings that occur after discovery has commenced (which would be the case if, for example, the board's considerations were only described in the minutes of a board meeting).

6 While Rule 12d1-1 does not explicitly require such fees to be reimbursed or waived, plaintiffs rely on language in the Rule's proposing release that states: "to the extent advisory services are being performed by another person, such as the adviser to an acquired money market fund, [the Section 36(b)] fiduciary duty would require an acquiring fund's adviser to reduce its fee by the amount that represents compensation for the services performed by the other person." However, the Rule's adopting release also states: "A fund could pay duplicative fees if an adviser invests a fund's cash in a money market fund (which itself pays an advisory fee) without reducing its advisory fee by an amount it was compensated to manage the cash. Fund directors have fiduciary duties, which obligate them to protect funds from being over-charged for services provided to the fund, regardless of any special findings we might require."

SEC Guidance and Sweep Examination for Bond Funds

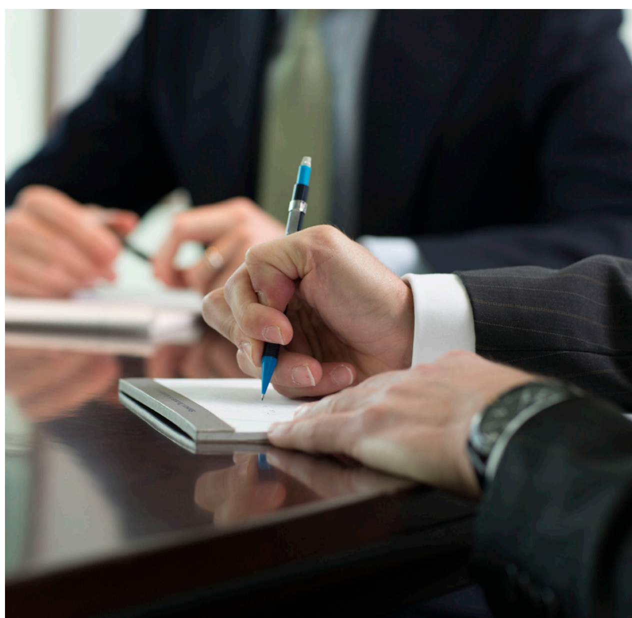
Beginning in January 2014, the SEC has indicated a focus on the effect that changing interest rates have on bond funds. In the OCIE's 2014 Examination Priorities, OCIE indicated that it would be monitoring the risks that a changing interest rate environment would pose to bond funds as well the appropriate disclosures to investors relating to such changes. Soon thereafter, the Division of Investment Management released a new guidance update regarding risk management in changing bond market conditions, which outlined several measures for fund advisers to consider, including: conducting fund liquidity stress tests; reviewing the adequacy of communications with fund boards, which allows the boards to oversee responses to manage effectively changing interest rate environments; and reviewing the adequacy of shareholder disclosures in light of these additional interest rate risks.

In September 2014, Staff announced plans to conduct a sweep examining between twenty-five and thirty fund complexes to review how well prepared bond funds are for a changing interest rate market and the adequacy of disclosures, among other subjects. The sweep information requests that have been sent by the SEC thus far include, among other things, requests related to: liquidity (including policies and procedures, responsible overseers, compliance risks, breakdown of liquid and illiquid assets, a description of the redemption lines of credit and procedures for and results of stress tests); general compliance reports and other documents; minutes of meetings; membership of the board and its committees and a board self-assessment; and other general fund and portfolio information. Accordingly, bond fund managers that have not already received such a request from the SEC should examine their preparedness for responding to such a request and, more generally, their preparedness for changes in interest rate environments.

SEC Weighs in on Non-Transparent Actively Managed ETF Proposals

In the past few months, there has been a flurry of SEC activity in the non-transparent actively managed exchange-traded fund (ETF) space. As the ETF industry continues to grow at a blistering pace, with global assets under management recently eclipsing the $2.5 trillion mark, actively managed ETFs present a new opportunity for asset managers to grow market share. Traditionally, the advantage of offering ETFs as opposed to mutual funds has been in tax efficiencies and externalization of trading costs to the fund. Even where those advantages are blunted (for example, because creation units are purchased and redeemed in cash instead of in-kind), ETFs are attractive to certain investors who wish to use their existing brokerage accounts or who prefer intraday pricing. The ETF channel is, therefore, an attractive distribution channel for many fund sponsors at a minimum.

However, actively managed ETFs currently represent less than one percent of total ETF assets under management in the U.S., partially as a result of the SEC requirement of daily portfolio disclosure. While the benefits of actively managed ETFs seem clear, thus far fund transparency requirements have stunted the growth of this market. In the past quarter, there have been significant developments relating to these transparency requirements.



Non-Transparent Active ETF Proposals

Under current exemptions granted to sponsors of ETFs, actively managed ETFs are required each day to publish their entire portfolio holdings to the public. Traditional mutual funds, on the other hand, are only required to disclose their portfolio holdings on a quarterly basis, and even then on a delayed basis. From a sponsor's point of view, a major drawback of portfolio transparency is that it allows potential front-runners to anticipate an ETF's positions by buying or shorting the securities that the ETF is looking to purchase or sell. Moreover, the daily disclosure requirements make it difficult for fund managers to disguise their investment tactics and strategies more generally.

In a bid to limit SEC disclosure requirements, several sponsors have submitted proposals to the SEC requesting exemptions that would permit less transparency. The BlackRock and Precidian proposals utilize a blind-trust mechanism placed between the ETF and the authorized participant, which acts as a screen preventing the public, and the authorized participant, from viewing the fund's underlying assets. T. Rowe Price's proposal advocates for replacing full-portfolio disclosure with partial disclosure of a daily hedge portfolio in which each fund invests at least 80% of its total assets, acting as a type of proxy basket. In addition, investors would be provided data points detailing the differences between the actual portfolio and the hedge portfolio to narrow the differential between the proxy and actual baskets.

Lastly, Eaton Vance's proposal advances a novel mutual fund-ETF hybrid called an exchange traded mutual fund (ETMF). ETMFs possess characteristics of both ETFs and mutual funds. Like ETFs, ETMFs would issue and redeem large chunks of shares known as "creation baskets" to and from authorized participants primarily via in-kind transfers composed of the fund portfolio's underlying securities. The authorized participants would then trade the shares on a national security exchange where retail investors can purchase the shares in smaller quantities.

Perhaps most important to Eaton Vance, portfolio disclosure would only be required on a quarterly basis. In order to protect the confidentiality of the fund's holdings, ETMF advisers would decide which underlying securities to include in the creation baskets issued to authorized participants with the balance paid in cash. This allows ETMFs to disguise the implementation of their investment strategy and make predatory front running a more difficult endeavor.

The pricing mechanism for ETMFs is novel. Shares would trade throughout the day on exchanges at prices quoted relative to NAV (plus or minus a premium or discount decided by market makers); however, the final transaction price would not be locked in until the end of the day when the NAV is calculated. The result is that investors would know the premium or discount at the time of each trade, but like intraday orders to buy or sell shares of mutual funds, an ETMF investor would not know the NAV (and thereby the final price per share) at the time the order is placed. The amount of the premium/discount would depend on a myriad of market factors, including the balance of supply and demand for shares among investors, the transaction fees and other costs associated with creating and redeeming creation units, competition among market makers, share inventory positions, inventory strategies of market makers and the volume of share trading.

Eaton Vance's proposal allows ETMFs to benefit from the tax efficiencies and cost savings of an ETF, accomplished through in-kind transfers that pass on a portion of the costs to authorized participants, plus the more limited quarterly transparency requirements of a traditional mutual fund.

The SEC Responds

Almost two weeks after the SEC published notices (click here and here for links to the notices) stating its intent to deny exemptive relief requests sought by BlackRock and Precidian, the SEC published a notice of intention on November 6, 2014 giving preliminary approval to Eaton Vance's ETMF request. The SEC has not yet commented on T. Rowe Price's proposal, the last amendment to which was submitted in March 2014.

SEC is Critical of BlackRock and Precidian Proposals

ETFs are permitted to function pursuant to SEC exemptive relief from various provisions of the 1940 Act. A hallmark of these exemptions is the SEC's expectation that ETF shares trade at a price that is as close as possible to the NAV per share of the ETF. Historically, the SEC has viewed daily portfolio transparency as one key mechanism that ensures that market prices of ETF shares are close to the NAV. The theory is that transparency provides authorized participants sufficient information to implement an effective arbitrage strategy.

In their applications, BlackRock and Precidian propose several novel mechanisms that would enable them to operate on a less transparent basis while at the same time purportedly preserving market makers' ability to capitalize on arbitrage opportunities in the market:

- The funds would be required to disclose portfolio holdings on a quarterly basis instead of on a daily basis similar to traditional mutual funds.
- Authorized participants would have access to an intraday indicative value (IIV) disseminated by exchanges every 15 seconds during the trading day, based on the last available market quotation or sale price of the ETF's portfolio holdings. However, the applicants concede that the IIV is not a real-time NAV for the ETF and would not include extraordinary expenses or liabilities booked during the day.
- Blind trusts would be established whereby authorized participants could purchase or redeem creation baskets by paying cash to the trusts which would then transact with the ETFs via in-kind transfers of the fund's securities without revealing the identity of the ETF's underlying portfolio contents to authorized participants or the general public.
- Retail investors would be able to redeem individual shares directly from the ETFs in the event of a persistent and significant deviation of closing market price from the NAV, subject to a redemption fee of up to 2% and additional brokerage commissions.

The SEC disagreed with the assertion by Blackrock and Precidian that the proposed mechanisms would keep the market share price close to the NAV. Specifically, the SEC stated: "the specific features proposed by the Applicants that would cause the proposed ETFs to operate without transparency fall far short of providing a suitable alternative to the arbitrage activity in ETF shares that is crucial to helping keep the market price of current ETF shares at or close to the NAV per share of the ETF." The SEC release also casts doubt on the use of IIV or blind trusts as alternative mechanisms to ensure appropriate arbitrage opportunities, a key factor in previous SEC exemptions.

The SEC stated that the use of IIV in place of real-time data could result in inaccurate calculations of share price, particularly in times of market stress or volatility. The SEC was unconvinced that IIV would serve as a good substitute for the transparency of a fund's underlying holdings—a necessary component to provide information to enable effective arbitrage by market makers. The SEC noted that in the case of transparent ETFs, market makers calculate their own NAV using proprietary algorithms based on the ETFs'

actual holdings and they only use IIV as a secondary or tertiary indicator of ETF share value. If market makers can no longer calculate their own NAV based on the value of an ETF's underlying assets, then arbitrage opportunities will be limited, causing market makers to hesitate to trade under such conditions. The SEC also voiced concern that because there are no uniform methodology requirements in calculating the IIV, it could result in potentially arbitrary and inconsistent valuations.

Additionally, the release highlighted the SEC's concern that quarterly disclosure of portfolio holdings would be insufficient and quickly lose relevance as ETF's holdings could change daily (although it is not clear why that is more true for ETFs than other products that disclose holdings quarterly). Finally, the SEC was not convinced that the proposed back-up mechanism would be utilized by retail investors or provide an effective backstop to authorized participant arbitrage.

SEC Approves ETMF Structure

On the other hand, on December 2, 2014 the SEC issued an order approving the proposal advanced by Eaton Vance, after initially granting approval on November 7 for NASDAQ to list ETMF shares. Eaton Vance has created a structure that enjoys the benefits of ETFs' lower operating costs and enhanced tax efficiencies, without the burden of daily disclosure requirements. Eaton Vance's proposal persuaded the SEC that unlike the BlackRock and Precidian pricing mechanisms, the ETMF structure would keep the market share price sufficiently close to NAV because shares would trade at a premium or discount based directly off of the NAV. The SEC evidently was satisfied that this will adequately protect retail investors without the benefit of portfolio transparency.

Eaton Vance has obtained patents with respect to certain aspects of ETMF's NAV-based trading pricing mechanism. Eaton Vance expects that investment advisers that desire to manage ETMFs will obtain a license from Eaton Vance and apply for a separate exemptive order from the SEC that incorporates by reference all the terms and conditions of Eaton Vance's order.[7]

Precidian Refiles

In the wake of the SEC's notice of its intent to deny Precidian's application, Precidian decided to pull its original application and refile with the hope of addressing the SEC's main concern, namely keeping the market price of ETF shares close to NAV. The first innovation of Precidian's application is that *each* authorized participant would establish a blind trust to transact on its behalf with the ETF. The ETF's portfolio holdings would be fully transparent to the blind trusts, which would allow them to calculate and convey a close approximation of the actual NAV to authorized participants. This mechanism would allow ETFs to maintain confidentiality from the public at large while maintaining a mechanism that would presumably keep the market share price close to NAV.

The second innovation advanced by Precidian's application is the verified intraday indicative value (VIIV). VIIV differs from IIV in that it will be calculated based on the currently quoted bid/ask midpoint price of the underlying securities (as opposed to the last sale of the underlying securities) and will include all accrued income and expenses of the fund in share quotes. Precidian asserts in its application that this will increase price reliability and accuracy. The funds will disclose to the blind trusts the identity of the securities and other price inputs so they can independently calculate and verify the fund's share price.

Looking Forward

Now that Eaton Vance has successfully run the SEC's regulatory gauntlet, the next question is whether investors will want to invest in actively managed ETMFs. In recent years, there has been a shift of investor capital away from actively managed mutual funds and ETFs towards index-based funds (including ETFs). Moreover, there will be a learning curve as investors try to comprehend the novel and somewhat complex pricing structure of ETMFs. Regardless, for many sponsors a "holy grail" has been accessing the ETF channel for actively managed strategies without full portfolio disclosure. Eaton Vance may have found it, and Precidian and others may not be far behind.

7 We are not expressing a view on the strength or validity of such patents.

4th Quarter 2014 Notable Transactions

M&A Transactions

- **American Beacon Advisors, Inc.**, a provider of investment advisory services to institutional and retail markets, announced that its parent company, Lighthouse Holdings, Inc., reached a definitive agreement to be acquired by investment funds affiliated with **Kelso & Company** and **Estancia Capital Management**, two leading private equity firms. Lighthouse Holdings, Inc. is majority owned by investment funds affiliated with **TPG Capital** and **Pharos Capital Group, LLC.** As of September 30, 2014, American Beacon Advisors had $57.2 billion in assets under management.
- **Wunderlich Securities**, a full-service investment firm headquartered in Memphis, announced an agreement to acquire the wealth management assets of **Dominick & Dominick LLC**, a privately held investment firm based in New York, New York. Following the acquisition, the purchased business will operate as Dominick & Dominick, a division of Wunderlich Wealth Management, Wunderlich's private client group.
- **American Realty Capital Properties, Inc.** announced that it signed an agreement for the sale of **Cole Capital**, ARCP's private capital management business, to **RCS Capital Corp.** for at least $700 million. As part of the transaction, ARCP will act as sub-advisor to Cole Capital's non-traded real estate investment trusts (the "Managed Funds") and acquire and property manage net lease real estate assets for the Managed Funds. ARCP also agreed to source, underwrite and acquire U.S. net lease properties for American Realty Capital Global Trust II, Inc.
- **BNY Mellon** announced that it reached an agreement to acquire **Cutwater Asset Management**. Upon completion of the deal, Cutwater will operate as part of BNY Mellon Investment Management and will work closely with, and be administered by, **Insight Investment**, one of BNY Mellon's investment management boutiques. Cutwater is a U.S.-based fixed income and solutions specialist with approximately $23 billion in assets under management.
- **Janus Capital Group Inc.** reported that it agreed to acquire **VS Holdings Inc.**, the parent company of **VelocityShares, LLC**, a provider of exchange-traded products, including exchange-traded funds. As of September 2014, VelocityShares had raised approximately $2 billion in assets across 21 investment products.
- **Old Mutual Wealth** reached an agreement to acquire **Quilter Cheviot** for a consideration of up to £585 million. Following approval from regulators, Quilter Cheviot will become the discretionary investment management business within Old Mutual Wealth.
- Austrian lender **BAWAG P.S.K.** and France-based **Amundi Group SA** announced BAWAG P.S.K.'s sale of its asset management arm, **BAWAG P.S.K. Invest**, to Amundi. Amundi, which has more than €800 billion under management, intends to continue operating Invest out of Austria. As of June 2014, Invest had €4.6 billion under management.
- **Ares Management, L.P.** (NYSE: ARES) announced that its subsidiary reached an agreement to acquire **Energy Investors Funds** for an undisclosed sum, to be financed primarily in cash, including a portion of the proceeds raised from a prior offering of senior notes by an indirect subsidiary of Ares, and with equity interests in Ares. The transaction was expected to close by the end of 2014 and is subject to regulatory approval. Energy Investors Funds, founded in 1987, is an asset manager in the energy infrastructure industry and has approximately $4 billion of assets under management.
- **Affiliated Managers Group, Inc.**, a global asset management company, announced the completion of its investment in **Veritas Asset Management LLP**. As part of the transaction, Veritas' senior professionals agreed to long-term commitments with the firm.
- **BlackRock Kelso Capital Advisors LLC** entered into an agreement to sell certain of its assets to **BlackRock Advisors, LLC**, a wholly-owned subsidiary of BlackRock, Inc. Contingent upon BKCA stockholder approval and subject to other closing conditions, BlackRock Advisors will serve as BKCA's investment manager following the completion of the transaction.
- **Securian Financial Group** announced that it agreed to acquire a majority interest in **Asset Allocation & Management Company**, a Chicago-based insurance asset manager, from a private equity fund managed by Stone Point Capital and related investors. AAM will operate independently within Securian following the acquisition and be governed by its own board of directors. Securian is one of the largest financial service providers in the nation, holding close to $46 billion in assets under management and more than $1 trillion of insurance in force. AAM manages $16.4 billion in insurance company assets.

- **Mercer**, a wholly owned subsidiary of Marsh & McLennan Companies (NYSE: MMC), announced that it agreed to acquire **SCM Strategic Capital Management AG**, an independent Swiss-based investment advisor and solutions provider for institutional investors. SCM is based in Zurich and has offices in Luxembourg and Hong Kong. The firm is a leading investor for private market fund investments and advises on or manages portfolios with a net asset value of $4 billion.
- **New York Life Investment Management** subsidiary of New York Life Insurance Co. agreed to acquire Rye Brook, New York-based asset manager **IndexIQ**. The ETF and liquid alternatives manager, which has 12 funds including its IQ Hedge Multi-Strategy Tracker ETF, will join New York Life's MainStay Investments platform. The acquisition will add $1.5 billion to MainStay's $101 billion in assets under management.
- **Affiliated Managers Group**, announced that it agreed to meaningfully increase its minority ownership interest in **AQR Capital Management, LLC**. AQR's principals will maintain majority ownership in AQR, as well as operational independence. Founding Principals Clifford S. Asness, David G. Kabiller and John M. Liew, as well as the firm's other 18 Principals, entered into long-term commitments with the firm.

Closed-End Fund Initial Public Offerings

BlackRock Science and Technology Trust (NYSE: BST)

- Amount Raised: $420.0 million
- Investment Objectives/Policies: The company's investment objectives are providing income and total return through a combination of current income, current gains and long-term capital appreciation. Under normal market conditions, the fund will invest at least 80% of its total assets in equity securities issued by U.S. and non-U.S. science and technology companies in any market capitalization range, selected for their rapid and sustainable growth potential from the development, advancement and use of science and/or technology (high growth science and technology stocks), and/or potential to generate current income from advantageous dividend yields (cyclical science and technology stocks).
- Investment Adviser: BlackRock Advisors, LLC
- Book-runners: Morgan Stanley & Co. LLC, Merrill Lynch, Pierce, Fenner & Smith Incorporated, UBS Securities LLC and Wells Fargo Securities, LLC

Eagle Point Credit Company Inc. (NYSE: ECC)

- Amount Raised: $103.1 million
- Investment Objective/Policies: The fund's investment objective is to generate high current income and capital appreciation primarily through investment in equity and junior debt tranches of collateralized loan obligations.
- Investment Adviser: Eagle Point Credit Management LLC
- Book-runners: Deutsche Bank Securities Inc. and Keefe, Bruyette & Woods, Inc.

Miller/Howard High Income Equity Fund (NYSE: HIE)

- Amount Raised: $245.0 million
- Investment Objectives/Policies: The fund's primary investment objective is to seek a high level of current income. As a secondary objective, the fund seeks capital appreciation. The Fund will attempt to achieve its investment objectives by investing, under normal market conditions, at least 80% of its total assets in dividend or distribution paying equity securities of U.S. companies and non-U.S. companies traded on U.S. exchanges. The Fund will terminate on November 24, 2024, absent shareholder approval to extend the term. If the Fund's Board of Trustees believes that under then current market conditions it is in the best interests of the Fund to do so, the Fund may extend the termination date for one year, to November 24, 2025, without a shareholder vote, upon the affirmative vote of three-quarters of the Trustees then in office.
- Investment Adviser: Miller/Howard Investments, Inc.
- Book-runners: Wells Fargo Securities, LLC, Raymond James & Associates, Inc. and Ameriprise Financial Services, Inc.

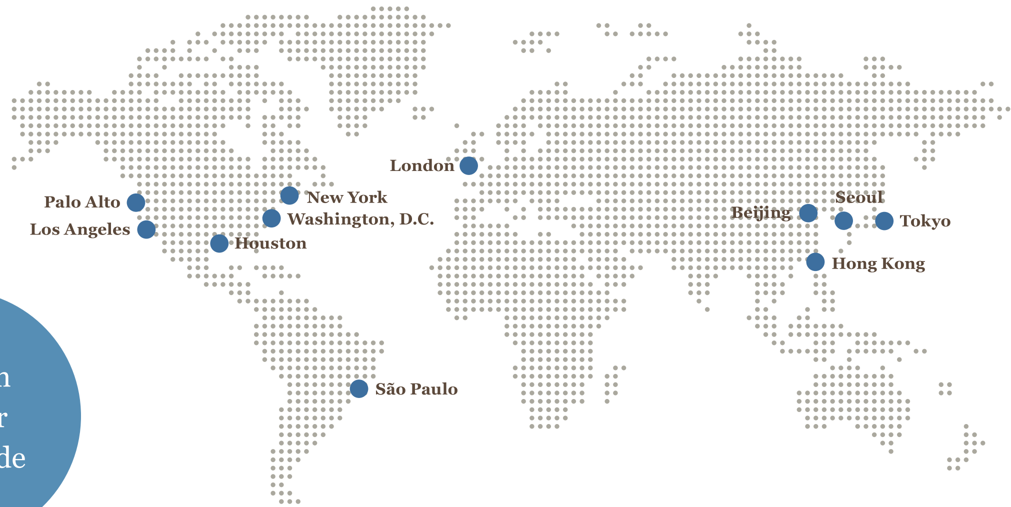
Simpson
Thacher

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

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

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

The contents of this publication are for informational purposes only. Neither this publication nor the lawyers who authored it are rendering legal or other professional advice or opinions on specific facts or matters, nor does the distribution of this publication to any person constitute the establishment of an attorney-client relationship. Simpson Thacher & Bartlett LLP assumes no liability in connection with the use of this publication. Please contact your relationship partner if we can be of assistance regarding these important developments. The names and office locations of all of our partners, as well as our recent memoranda, can be obtained from our website, www.simpsonthacher.com.



UNITED STATES

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

Houston
2 Houston Center
909 Fannin Street
Houston, TX 77010
+1-713-821-5650

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

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

Washington, D.C.
1155 F Street, N.W.
Washington, D.C. 20004
+1-202-636-5500

EUROPE

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

ASIA

Beijing
3919 China World Tower
1 Jian Guo Men Wai Avenue
Beijing 100004
China
+86-10-5965-2999

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

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

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

SOUTH AMERICA

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