

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT COMPANY ACT OF 1940
Release No. 31455 / February 12, 2015

ADMINISTRATIVE PROCEEDING
File No. 3-16385

In the Matter of

Water Island Capital LLC,

Respondent.

ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 9(f) OF THE INVESTMENT COMPANY ACT OF 1940, MAKING FINDINGS, AND IMPOSING A CEASE-AND-DESIST ORDER

I.

The Securities and Exchange Commission (“Commission”) deems it appropriate and in the public interest that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 9(f) of the Investment Company Act of 1940 against Water Island Capital LLC (“Water Island” or “Respondent”).

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the “Offer”) which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission’s jurisdiction over it and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Cease-and-Desist Proceedings Pursuant to Section 9(f) of the Investment Company Act of 1940, Making Findings, and Imposing a Cease-and-Desist Order (“Order”), as set forth below.

III.

On the basis of this Order and Respondent’s Offer, the Commission finds that

1. Water Island, founded in 2000 and based in New York, New York, is, and at all times relevant herein has been, a registered investment adviser with the Securities and Exchange Commission. Water Island currently serves as the investment adviser to several registered open-

end management investment companies, commonly known as mutual funds. Water Island, which currently manages approximately \$3.5 billion in assets, engages in specialized trading strategies including, among others, merger arbitrage.¹ To carry out its strategies, Water Island trades equities and derivatives including swaps. Because of the trading strategies employed by Water Island, the investment companies managed by it (the “Funds”) are commonly referred to as alternative mutual funds.

2. All registered investment companies are subject to the Investment Company Act of 1940 (“Investment Company Act”) and the rules and regulations thereunder [15 U.S.C. § 80a-1 *et seq.*]. Investment companies, as defined by statute, are “affected with a national public interest.”

3. A focus of the Investment Company Act is to protect investment company assets.

4. The Investment Company Act requires all registered management investment companies to comply with strict rules governing custody of fund assets. The Funds maintained custody with a qualified bank. Section 17(f)(5) of the Investment Company Act generally provides that if an investment company maintains its securities and similar investments in the custody of a qualified bank, the cash proceeds from the sale of such securities and similar investments and other cash assets of the investment company shall likewise be kept in the custody of such a bank. In accordance with this section, the Funds’ compliance procedures during at least 2012 – which designated Water Island with the responsibility for overseeing compliance with the Funds’ custody requirements – provided that each Fund “shall maintain its securities and similar investments, the cash proceeds from the sale of such securities and similar investments and other cash assets ... in the custody of a qualified bank.”

5. From at least January to September 2012, however, Water Island did not ensure that certain assets of the Funds were maintained in the custody of the Funds’ qualified bank. The Funds’ broker-dealer counterparties instead held assets consisting of roughly \$247 million in cash collateral. Water Island caused the Funds to post the contractually required cash collateral relating to certain total return and portfolio return swaps. Water Island did not ensure the transfer of these assets to the Funds’ qualified bank as required by Section 17(f)(5) of the Investment Company Act and the Funds’ policies and procedures.²

6. The Investment Company Act and its rules provide further protections for fund assets, including provisions governing the use of fund assets to pay broker-dealers and others for the sale or distribution of fund shares.

¹ Merger arbitrage frequently involves purchasing shares of an announced acquisition target company at a discount to their expected value upon completion of the merger.

² The cash collateral could have, for example, been maintained with the Funds’ custodian bank subject to a tripartite agreement, that is, a three-way agreement between the custodial bank, the counterparty, and the Fund. These agreements are standard industry practice.

7. Use of fund brokerage, or amounts used to effect portfolio securities transactions, to pay for expenses related to the distribution of fund shares implicates Rule 12b-1 under the Investment Company Act. While fund advisers choose which broker or dealer will effect securities transactions on behalf of a fund, fund brokerage is an asset of the fund. Rule 12b-1 under the Investment Company Act regulates the use of fund assets to pay for distribution expenses, and Section 12(b) of the Investment Company Act prohibits funds from distributing their own shares (except through a principal underwriter) in contravention of Commission rules. Under Rule 12b-1(h), funds are prohibited from compensating a broker-dealer for promoting or selling fund shares by directing brokerage transactions to that broker. Rule 12b-1(h) recognizes, however, that for some portfolio transactions, the broker-dealer that can provide best execution may also sell the fund's shares.³ Therefore, a fund is permitted to direct fund portfolio transactions to brokers that sell fund shares only if the fund or its adviser has implemented policies and procedures reasonably designed to, among other things, ensure that the selection of brokers for portfolio securities transactions is not influenced by considerations about the sale of shares of that or any other fund.

8. The Funds' policies and procedures concerning Rule 12b-1(h) were not implemented following their adoption. As required by the relevant policies and procedures concerning Rule 12b-1(h), Water Island had the responsibility for implementing the policies and procedures designed to ensure that any broker selected to execute securities transactions was chosen in accordance with the Rule. Water Island failed to create and maintain an approved list of executing brokers for the Funds pursuant to the Rule 12b-1(h) policies and procedures, and also failed to maintain documentation reflecting monitoring of the Funds' compliance with the Rule 12b-1(h) policies and procedures, as required by the policies and procedures themselves.

9. As a result of the conduct described above, Water Island caused the Funds to violate Sections 12(b) and 17(f) of, and Rule 12b-1(h) under, the Investment Company Act.

10. Rule 38a-1 under the Investment Company Act requires registered investment companies to adopt and implement written policies and procedures reasonably designed to prevent violations of the federal securities laws, and to review those policies and procedures at least annually for their adequacy and the effectiveness of their implementation. As described above, the Funds violated Section 17(f) of the Investment Company Act and did not implement their policies and procedures concerning Section 17(f) of, as well as Rule 12b-1(h) under, the Investment Company Act. As a result, the Funds violated Rule 38a-1 under the Investment Company Act, and Water Island caused the Funds' violations of Rule 38a-1 under the Investment Company Act.

³ Prohibition on the Use of Brokerage Commissions to Finance Distribution, Investment Company Act Rel. No. 26591 (Sept. 2, 2004) at Section II.B.

Remedial Efforts

In determining to accept the Offer, the Commission considered remedial acts promptly undertaken by Respondent and cooperation afforded the Commission staff.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondent's Offer.

Accordingly, pursuant to Section 9(f) of the Investment Company Act, it is hereby ORDERED that:

A. Respondent cease and desist from committing or causing any violations and any future violations of Sections 12(b) and 17(f) of the Investment Company Act, and Rules 12b-1 and 38a-1 promulgated under the Investment Company Act.

B. Respondent shall, within ten days of the entry of this Order, pay a civil money penalty in the amount of \$50,000 to the Securities and Exchange Commission. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. § 3717. Payment must be made in one of the following ways:

- (1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
- (2) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or
- (3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying Water Island Capital LLC as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to Amelia A. Cottrell, Associate Director, Division of Enforcement, Securities and Exchange Commission, 200 Vesey Street, Suite 400, New York, New York 10281.

By the Commission.

Brent J. Fields
Secretary