Investment Management Regulatory Update

June 24, 2013

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SEC Rules and Regulations

SEC Proposes Amendments to Money Market Fund Rules

On June 5, 2013, the Securities and Exchange Commission (the "**SEC**") proposed amendments to rules under the Investment Company Act of 1940 (the "**Investment Company Act**") and related requirements that govern money market funds ("**MMFs**"). The SEC's proposal is the latest action taken by U.S. regulators as part of the ongoing debate about systemic risks posed by MMFs and the extent to which previous reform efforts have addressed these concerns.

As discussed in detail in the June 11, 2013 Davis Polk Client Memorandum, ***SEC Proposes Amendments to Money Market Fund Rules***, the proposal sets out two alternative reforms to Rule 2a-7 under the Investment Company Act. Under the first of the two alternative reforms, prime institutional MMFs would no longer be permitted to rely on the provisions in Rule 2a-7 that allow them to maintain a stable $1 per share net asset value ("**NAV**"). Under the second alternative, all MMFs could maintain a stable NAV but could, subject to action by the fund's board of directors, impose liquidity fees and gates against investor redemptions if the fund's weekly liquid assets fell below 15% of its total assets. The proposal also would modify other requirements for all MMFs, including the Rule 22e-3 provisions relating to suspension of redemptions, and would impose new disclosure and reporting requirements on MMFs.

- **See a copy of the SEC's proposal**

SEC Proposes Rules to Regulate Cross-Border Security-Based Swap Activities

On May 1, 2013, the SEC released proposed rules (the "SEC Proposal") that would govern cross-border activities in security-based swaps. Notably, the approach taken by the SEC with respect to security-based swap activities differs from the approach taken by the Commodity Futures Trading Commission with respect to transnational swap activities (the "CFTC Proposal"). Under the SEC Proposal, the security-based swap regulatory regime would generally apply to security-based swap activities involving (i) a "U.S. person" and/or, (ii) under a so-called "territorial approach" to U.S. jurisdiction of security-based

swap activity, a "transaction conducted within the United States." Under the SEC Proposal, a "U.S. person" would include any natural person resident in the United States, any partnership, corporation, trust or other legal person organized or incorporated under the laws of the United States or having its principal place of business in the United States, any account (whether discretionary or nondiscretionary) of a U.S. person, as well as a foreign branch, agency or office of a U.S. person (but would exclude foreign central banks and international multilateral organizations such as members of the World Bank Group, the International Monetary Fund, the United Nations and similar organizations, among others, or their agencies and pension plans). The SEC Proposal's definition of U.S. person differs from the definition of U.S. person under the CFTC Proposal and, according the SEC Proposal, the SEC considered, but explicitly declined to adopt, the definition used in Regulation S under the Securities Act of 1933.

Under the SEC Proposal, the term "transaction conducted within the United States" includes any security-based swap that is "solicited, negotiated, executed, or booked within the United States, by or on behalf of either counterparty to the transaction, regardless of the location, domicile, or residence status of either counterparty to the transaction." The SEC clarified that it would not view clearing, reporting or engaging in collateral management for a security-based swap within the United States as causing that transaction to be considered to be conducted within the United States. According to the SEC Proposal, a security-based swap transaction conducted through a foreign branch of a U.S. bank would not be a transaction conducted within the United States, subject to certain conditions. For further discussion of the SEC Proposal, including discussion of (1) the differences between the SEC Proposal and the CFTC Proposal, (2) obligations of security-based swap dealers, (3) reporting, clearing and trade execution requirements with respect to security-based swap activities, (4) *de minimis* calculations for security-based swap dealer registration and (5) "substituted compliance," a regime through which the SEC would allow security-based swap market participants to satisfy some U.S. security-based swap regulations by complying with foreign regulatory requirements (if the SEC has made a determination that substituted compliance is available), please see the May 16, 2013 Davis Polk Client Memorandum, ***SEC Proposes Cross-Border Security-Based Swap Rules***.

Comments on the SEC Proposal are due by August 21, 2013.

- **See a copy of the SEC's press release**
- **See a copy of the SEC Proposal**

IM Guidance Update Emphasizes Compliance with Exemptive Orders

On May 6, 2013, the Division of Investment Management of the SEC issued an IM Guidance Update for funds registered under the Investment Company Act and investment advisers that rely on exemptive orders issued by the SEC. According to the Division of Investment Management, the IM Guidance Update was issued in response to a June 2011 report issued by the SEC's Office of Inspector General, which, among other things, detailed deficiencies in the SEC's oversight of firms' compliance with the representations and conditions of SEC exemptive orders and made recommendations to improve the SEC's oversight in that regard. In warning investment advisers and registered funds of the risk of violating federal securities laws as a result of not complying with the representations and conditions of exemptive orders, the IM Guidance Update specifically identified (1) Rule 206(4)-7 under the Investment Advisers Act of 1940 (the "**Advisers Act**"), which requires investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violation of the Advisers Act and its rules and to conduct an annual review of the adequacy and the effectiveness of implementation of such policies and procedures and (2) Rule 38a-1 under the Investment Company Act, which requires registered funds to adopt and implement written policies and procedures (that must be approved by the fund's board) reasonably designed to prevent the fund from violating the federal securities laws and to conduct an annual review of the adequacy of the fund's policies and procedures. According to the IM Guidance Update, among the ways investment advisers and registered funds can seek to mitigate the risk of violating such laws is to adopt and implement written policies and procedures (as required under

Rule 206(4)-7 of the Advisers Act or Rule 38a-1 of the Investment Company Act, as applicable) "that are reasonably designed to ensure ongoing compliance with each representation and condition of the order." As an example, for a fund relying on an exemptive order that has conditions relating to a board review, the IM Guidance Update indicates that a fund could either (1) adopt a specific policy or procedure regarding the conditions of the board review or (2) consider whether an existing policy or procedure relating to board review of other matters sufficiently covers the conditions set forth in the exemptive order on which the fund is relying. In either case, according to the IM Guidance Update, annual review of the policy or procedure by the fund would be required to ensure adequacy and effectiveness of implementation.

The IM Guidance Update is the second such release by the Division of Investment Management. On March 15, the Division of Investment Management released an IM Guidance Update responding to inquiries about filing requirements for certain electronic communications, as discussed in the ***April 29, 2013 Investment Management Regulatory Update***. According to a March 15, 2013 SEC press release, the Division of Investment Management intends to issue additional IM Guidance Updates in the future addressing legal issues relevant to the investment fund industry.

- **See a copy of the IM Guidance Update**

Industry Update

ESMA Approves Cooperation Agreement Between EU Securities Regulators and SEC

On May 30, 2013, the European Securities and Markets Authority ("**ESMA**") announced that it had approved cooperation agreements between EU securities regulators and 34 non-European Union ("EU") regulators, including the SEC, as required by the Directive on Alternative Investment Fund Managers (the "**Directive**") and the AIFMD Delegated Regulations (the "**Level 2 Regulations**") in order for non-EU alternative investment fund managers ("**AIF Managers**") to manage or market alternative investment funds ("**AIFs**") in the EU after July 22, 2013.

In short, the Directive established a new regulatory framework for the authorization and supervision of AIF Managers that conduct business in the EU. The Directive allows AIF Managers to manage AIFs, including private equity funds and hedge funds, in the EU and market AIFs in the EU to "professional investors," subject to compliance with the conditions set forth in the Directive. See the ***December 17, 2010 Investment Management Regulatory Update*** for a detailed discussion on the Directive. The Level 2 Regulations are an extensive set of implementing measures that provide details on the framework established by the Directive. As with the Directive, the Level 2 Regulations may apply to EU AIF Managers and non-EU AIF Managers that manage or market one or more AIFs in the EU. Please see the ***February 27, 2013 Investment Management Regulatory Update*** for a detailed discussion of the Level 2 Regulations. For a detailed discussion of the specific effects of the Directive and the Level 2 Regulations on non-EU AIF Managers seeking to market non-EU AIFs to EU investors (including a discussion of the United Kingdom's implementing regulations that provide for a one year transitional period), please see the June 4, 2013 Davis Polk Client Memorandum, ***The Impact of the Alternative Investment Fund Managers Directive on Non-E.U. Managers of Non-E.U. Funds***.

According to ESMA's press release, ESMA negotiated the cooperation agreements on behalf of the regulatory authorities for each member state of the EU (each, an "**EU Member State**") as well as the regulators for Croatia, Iceland, Liechtenstein and Norway (together with the regulators of the EU Member States, the "**EU Regulators**"). According to ESMA, while it negotiated the cooperation agreements on behalf of the EU Regulators and has approved the cooperation agreements, each EU Regulator must sign a cooperation agreement with each non-EU regulator with which it intends to have a such an arrangement. According to ESMA's press release, the cooperation agreements approved by it will be publicly available on its website "in due course."

- See a copy of ESMA's press release

CFTC Adopts Rules on Swap Execution Facilities and Minimum Block Trade Sizes

On May 16, 2013, the Commodity Futures Trading Commission (the "**CFTC**") adopted final rules implementing certain provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**") relating to (1) the registration and operation of swap execution facilities ("**SEFs**"), (2) the Dodd-Frank Act's mandatory trade execution requirement and (3) the process for determining the threshold at which large swap transactions can qualify as "block trades" under the Dodd-Frank Act and the CFTC's rules. Among the adopted rules are:

- the so-called "SEF Rule" included under Part 37 of the CFTC regulations, which defines which types of trading platforms must register as SEFs, the core principles by which SEFs must operate and the execution methods that can be used to satisfy the trade execution requirement in Section 2(h)(8) of the Commodity Exchange Act (the "**CEA**");
- the so-called "Made Available to Trade Rule" included under Parts 37 and 38 of the CFTC regulations, which defines the procedures and criteria for determining that a swap that is required to be cleared is subject to the trade execution requirement; and
- the so-called "Block Trade Rule" included under Part 43 of the CFTC regulations, which defines which large trades will be disseminated to the public on a delayed basis under the CFTC's real-time reporting rules and will be exempt from certain trading rules.

Each of these rules is discussed in detail in the June 5, 2013 Davis Polk Client Memorandum, ***CFTC Finalizes SEF Rules and Adopts Minimum Block Trade Sizes***.

The SEF Rule and the Made Available to Trade Rule will become effective on August 5, 2013. The Block Trade Rule will become effective on July 30, 2013.

- See a copy of the SEF Rule
- See a copy of the Made Available to Trade Rule
- See a copy of the Block Trade Rule

CFTC Issues No-Action Relief from CPO Registration for Certain Delegating General Partners

On March 13, 2013, the Division of Swap Dealer and Intermediary Oversight (the "**Division**") of the CFTC issued four no-action letters granting relief from the requirement to register as a commodity pool operator ("**CPO**") to the general partner (with respect to a pool organized as a limited partnership) or managing member (with respect to a pool organized as a limited liability company) of certain commodity pools (each, a "**Pool**"). While the facts varied slightly among the no-action letters, generally, relief was granted allowing affiliated investment managers to whom the general partner or managing member had delegated all of its management authority to serve as the CPO of any such Pool, subject to the following conditions being met:

- The general partner or managing member, as applicable, and the investment manager are under common ownership and control;
- All investment authority has been delegated by the general partner or managing member, as applicable, to the investment manager and the general partner or managing member does not solicit investors for or manage assets of the Pool;
- The investment manager is registered or is in the process of registering as a CPO with the CFTC;

- The books and records of the general partner or managing member, as applicable, are maintained at offices of the investment manager;
- The general partner or managing member, as applicable, does not have any employees (or other person acting on its behalf) and is not otherwise subject to regulation under the CEA or the CFTC regulations (including with respect to activities that would require registration as a commodity trading advisor); and
- The general partner or managing member, as applicable, is not statutorily disqualified under Section 8a(2) or Section 8a(3) of the CEA.

These letters are consistent with relief previously granted by the CFTC staff, including the Division's Frequently Asked Questions (the "**FAQ**") regarding CPO and CTA compliance obligations that was issued on August 14, 2012. In the FAQ, the Division indicated generally that such delegations would be permissible, provided that requirements similar to those set forth in no-action letters issued prior to the release of the FAQ were met. The FAQ was discussed in detail in the ***September 26, 2012 Investment Management Regulatory Update***.

- **See a copy of CFTC Letter No. 13-17**
- **See a copy of CFTC Letter No. 13-18**
- **See a copy of CFTC Letter No. 13-19**
- **See a copy of CFTC Letter No. 13-20**
- **See a copy of the FAQ**

Litigation

SEC Charges Investment Adviser with Improperly Reallocating Trades Among Client Accounts

On April 19, 2013, the SEC settled charges against Foxhall Capital Management, Inc. ("**Foxhall**"), a registered investment adviser ("**RIA**"), and Paul G. Dietrich ("**Dietrich**"), Foxhall's Chief Executive Officer, Co-Chief Investment Officer and former Chief Compliance Officer, for reallocating trades among its client accounts in violation of its written compliance policies and procedures and for failing to maintain complete and accurate records of its trading and reallocation procedures.

According to the SEC, Foxhall offers clients discretionary portfolio management based on model portfolios that are designed to meet a client's investment goals and risk tolerance. According to the SEC, in managing such portfolios, Foxhall would aggregate client orders in block trades, then allocate trades to clients according to its clients' chosen model portfolio and the clients' account balances. According to the SEC, however, between January 1, 2007 and September 3, 2009, Foxhall's trade management system was incompatible with its primary broker dealer and custodian's trading platform, which caused real-time trade reconciliation problems. Specifically, the SEC alleged that Foxhall traders sometimes did not have accurate real-time information from the custodian regarding the current account balances of Foxhall's clients, which led to certain Foxhall clients being allocated shares from block trades despite not having sufficient funds in their accounts to purchase the shares, which caused such shares to become "unallocated shares." The SEC alleged that Foxhall would learn about the unallocated shares three to five days later, at which point Foxhall would, using the now stale original execution price, reallocate the unallocated shares to other client accounts with sufficient funds that were assigned to the same model portfolio (or alternatively, Foxhall would sell the unallocated shares through its own error account). The SEC alleged that this practice caused clients who were reallocated shares (or Foxhall, if unallocated shares were sold through its error account) to sometimes overpay or underpay for the reallocated shares,

since the shares' prices might have increased or decreased since the original execution of the block trade.

According to the SEC, rather than treat the more than 400 instances in which Foxhall reallocated shares as trading errors, which, under Foxhall's compliance procedures, would have required Foxhall to document the errors, to conduct a profit and loss analysis and to repay clients for losses, Foxhall deemed the reallocations to be "administrative errors." According to the SEC, however, Foxhall should have kept complete and accurate records concerning its trades, including with respect to its unallocated share practices. In addition, the SEC alleged that Foxhall and Dietrich failed to conduct an annual review of the firm's written compliance policies and procedures.

Based on such conduct, the SEC charged that Foxhall violated (and that Dietrich aided and abetted Foxhall's violation of) Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, which requires RIAs to implement policies and procedures reasonably designed to prevent violations of the Advisers Act and its rules (and for RIAs to review such policies and procedures annually) and Section 204 of the Advisers Act and Rule 204-2(a)(3) thereunder, which requires, among other things, that an RIA keep a record of each order given or instruction received for the purchase or sale of a security (including any "modification or cancellation" of any such order or instruction).

Without admitting or denying the SEC's findings, Foxhall and Dietrich agreed to settle the charges. The SEC censured Foxhall and Dietrich, ordered each to cease and desist from future violations of the relevant provisions of the Advisers Act, and ordered Foxhall to pay disgorgement and prejudgment interest and Foxhall and Dietrich to pay a civil penalty ($100,000 for Foxhall and $25,000 for Dietrich).

According to the SEC, in agreeing to the settlement, the SEC took into consideration Foxhall's and Dietrich's prompt remedial efforts, including that Foxhall changed it primary custodian, upgraded its trading platform, hired a compliance consultant to perform annual compliance reviews and to evaluate Foxhall's compliance practices and procedures, retained a third-party compliance consultant as its Chief Compliance Officer and hired an independent accountant to analyze the effect of reallocated shares on Foxhall's clients.

- **See a copy of the SEC's order**

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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