Investment Management Regulatory Update

July 18, 2013

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SEC Rules and Regulations

SEC Adopts Rules to Eliminate General Solicitation Ban and Proposes other Private Offering Reforms Mandated by JOBS Act

As mandated by Section 201(a) of the Jumpstart Our Business Startups Act, on July 10, 2013, the Securities and Exchange Commission (the "**SEC**") adopted final rules to permit advertising and other forms of "general solicitation" in private offerings made in reliance on Rule 506 of Regulation D of the Securities Act of 1933, so long as the purchasers in the offering are accredited investors. Notably, the final rules differ from the rules proposed on August 29, 2012 (as discussed in the September 4, 2012 Davis Polk Client Newsflash, ***SEC Issues Proposal to Eliminate General Solicitation Ban as Mandated by the JOBS Act***) in that the final rules include a non-exclusive list of methods, in respect of natural person investors, to satisfy the requirement that an issuer that uses general solicitation in a Rule 506 offering take "reasonable steps" to verify that the purchasers of the securities are accredited investors. The final rules will go into effect 60 days after publication in the Federal Register.

In addition, the SEC proposed other amendments to Regulation D under the Securities Act that would, among other things, (1) require additional information on Form D, (2) require that additional Form D filings be made if general solicitation is used in a Rule 506 offering and (3) impose additional requirements – primarily disclosure-related – on private fund general solicitation materials, but that would stop short of applying the full mutual fund advertising regime to private funds. Significantly, the proposed rules would impose content requirements for offerings by private funds, including specific requirements for advertisements containing performance data.

For further discussion of the final rules and SEC's proposed rules, please see the July 10, 2013 Davis Polk Client Newsflash, ***SEC Adopts Private Offering Reforms Mandated by JOBS Act***.

- See a copy of the final rules
- See a copy of the SEC's proposed rules

SEC Grants No-Action Relief to Adviser to Allow Subadvisers to Deliver Brochure Documents to Adviser Instead of Clients

On June 20, 2013, the Division of Investment Management of the SEC issued a no-action letter to Goldman, Sachs & Co. ("**GS&Co.**") stating that it would not recommend enforcement action to the SEC under Rule 204-3 under the Investment Advisers Act of 1940 against unaffiliated subadvisers hired by GS&Co. to manage client assets if the subadvisers deliver their Form ADV Parts 2A and 2B ("**Brochure Documents**") to GS&Co. instead of to the client.

Rule 204-3 under the Advisers Act generally requires registered advisers to deliver to prospective clients the information required by Form ADV and to deliver such information to existing clients on an annual basis. According to the no-action letter, GS&Co. has discretionary authority to manage its clients' assets under various programs and in managing such assets, GS&Co. uses the services of more than 40 unaffiliated subadvisers. According to the no-action letter, because the subadvisers may have an investment advisory relationship with the clients, the Advisers Act could require the subadvisers to provide their Brochure Documents to the clients. According to the no-action letter, however, the Division would not recommend enforcement action against subadvisers who did not provide their Brochure Documents to a client if:

- The client has appointed GS&Co. as adviser with discretionary authority to manage the client's assets (including the authority to hire subadvisers);
- GS&Co. offers the client a choice between (1) receiving the Brochure Documents of unaffiliated subadvisers directly or (2) allowing GS&Co. (as the client's agent) to receive such Brochure Documents, subject to GS&Co. providing the client with "sufficient information" to make an informed choice, including an explanation in "plain English of the information and disclosures in the Brochure Documents";
- GS&Co. identifies for the client any subadvisers hired by GS&Co.;
- GS&Co. retains copies of unaffiliated subadvisers' Brochure Documents for at least the period required by Rule 204-2 under the Advisers Act;
- GS&Co. provides copies of subadvisers' Brochure Documents if a client whose assets are being managed by the subadviser requests such documentation;
- GS&Co. maintains policies and procedures (including policies and procedures pursuant to Rule 206(4)-7 under the Advisers Act) designed to ensure, among other things, that subadvisers' Brochure Documents are "appropriately reviewed," that GS&Co. appropriately manages any material conflicts with a subadviser, and that GS&Co.'s engagement or termination of a subadviser's services is exercised in accordance with GS&Co.'s fiduciary obligations; and
- GS&Co. allows clients to change their election regarding the direct receipt of subadvisers' Brochure Documents without cost to the client.

According to the no-action letter, if GS&Co. determines that it has a material conflict of interest with a subadviser that it has hired to manage client assets (or in other circumstances that GS&Co. deems appropriate), GS&Co. "might seek to manage the conflict by sending that subadviser's Brochure Document to clients directly so they could evaluate the Brochure Document for themselves or suggest that clients engage another party to evaluate the conflict."

According to the no-action letter, because GS&Co. would, as agent for the clients, be "stepping in the shoes" of the clients as it relates to the receipt of subadvisers' Brochure Documents, GS&Co. would be "solely responsible for acting in the client's best interests with respect to any disclosure by the subadviser."

- See a copy of the no-action letter

Reminder Regarding Changes to Form 13F Filing Process

This is a reminder that, pursuant to the SEC Division of Investment Management's April 2013 IM Information Update and related previous notice to EDGAR Form 13F filers, Form 13F filers will be required to use the new online version of Form 13F (which is available on the EDGAR Filing Website) starting with the quarter ended June 30, 2013 (which would render such filings due by August 14, 2013 using the online form) and must complete their Form 13F Information Table in accordance with the EDGAR XML Technical Specification. Generally, Form 13F must be filed with the SEC by institutional investment managers with investment discretion over accounts holding Section 13(f) securities (as defined in rule 13f-1(c) under the Securities Exchange Act of 1934) that have an aggregate fair market value on the last trading day of any month of any calendar year of at least $100 million. Rule 13F filings must be made within 45 days after the end of such calendar year and within 45 days after the end of each of the first three calendar quarters of the subsequent calendar year.

- See a copy the IM Information Update
- See a copy of the SEC's notice

Industry Update

European Parliament Rejects Proposal to Cap UCITS Managers' Bonuses at 100% of Fixed Salary

On July 3, 2013, the European Parliament approved an amended text of the proposed fifth directive on Undertakings for Collective Investments in Transferable Securities ("**UCITS V**"). The proposal to cap the variable component of a UCITS manager's identified staff's remuneration at 100% of the fixed component was rejected (a similar cap was adopted with respect to certain employees of banks and investment firms under the capital requirements directive ("**CRD IV**")). As a result, it is now unlikely that a bonus cap along the lines of the one introduced under CRD IV will be adopted in the foreseeable future in relation to alternative investment fund managers.

The European Parliament has, however, introduced a number of new provisions as part of UCITS V that, if adopted in the final text, would provide that:

- competent authorities in Member States may require a UCITS manager to explain how its variable remuneration policy is consistent with the relevant UCITS V requirements;
- the European Securities Markets Authority ("**ESMA**") is empowered to monitor remuneration policies together with the competent authorities in Member States and, where a UCITS manager is in breach of the requirements in relation to remuneration, ESMA can make a recommendation to the relevant competent authority to prohibit temporarily or restrict the application of that manager's remuneration policy; and
- UCITS managers are obliged to have malus or clawback arrangements in place to allow them to reduce the variable remuneration component where the UCITS manager or the UCITS fund it manages suffers "*subdued or negative financial performance*".

The current text of UCITS V provides that the variable component of a UCITS manager's identified staff's remuneration must be based on both the individual's and the fund's performance with at least 50% of such variable component paid in units of the UCITS that they manage or similar instruments that create an equivalent ownership interest. At least 25% of the variable component must be deferred for at least 3 to 5 years (or less where the lifecycle of the relevant UCITS fund is shorter) to encourage managers to take a long term view. The salary restrictions apply to identified staff at UCITS managers, including, fund managers, persons who take investment decisions that affect the risk position of the fund, persons who exercise influence on staff, such as investment policy advisors and analysts, and senior management, risk takers and personnel in control functions.

The European Parliament, the European Council and the European Commission will now work together to produce a final text of UCITS V, which is expected in the third quarter of 2013. The restrictions on remuneration would likely be applicable from mid-2015.

- See a copy of the European Parliament's press release
- See a copy of the text of the proposed UCITS V Directive adopted by the European Parliament

Litigation

D.C. Circuit Upholds Dismissal of ICI and Chamber of Commerce Challenge to CFTC Amendments Affecting Registered Investment Companies

On June 25, 2013, the U.S. Court of Appeals for the District of Columbia affirmed the decision of a district court to dismiss the joint suit filed against the Commodity Futures Trading Commission (the "**CFTC**") by the Investment Company Institute and the U.S. Chamber of Commerce (collectively, the "**plaintiffs**"). The plaintiffs challenged the amendments to CFTC Rule 4.5 that significantly restrict the scope of the exclusion from commodity pool operator ("**CPO**") registration for investment companies registered under the Investment Company Act of 1940. Adopted by the CFTC in February 2012, the amendments effectively reinstated the conditions for meeting the CFTC Rule 4.5 exclusion that had been in effect prior to August 2003, including trading and marketing limits, with certain modifications that are discussed in the February 23, 2012 Davis Polk Client Memorandum, ***CFTC Adopts Amendments to Registration Exemptions for CPOs and CTAs and Proposes Harmonization Rules for Registered Fund CPOs***. For further discussions of the plaintiffs' original complaint and the decision of the district court, please see the ***April 19, 2012 Investment Management Regulatory Update*** and the ***January 22, 2013 Investment Management Regulatory Update***, respectively.

According to the Court of Appeals's opinion, the plaintiffs contended that the CFTC violated the Administrative Procedure Act in promulgating the amendments because the CFTC (i) failed to address its 2003 rationales for broadening CPO exemptions, (ii) failed to comply with the Commodity Exchange Act and failed to adequately evaluate the rule's costs and benefits, (iii) implemented rules that were arbitrary and capricious (the plaintiffs cited the CFTC's inclusion of "swaps" in the trading threshold, the CFTC's restrictive definition of bona fide hedging and the CFTC's alleged failure to justify the 5% registration threshold) and (iv) did not provide for an adequate notice and comment period.

In rejecting the plaintiff's claims, the Court of Appeals stated that an agency is not required to address previous rationales when, in a new rulemaking, the agency "changes course" and therefore the CFTC was not required to consider its rationales for broadening CPO exemptions in 2003. With respect to the plaintiffs' cost-benefit argument, the Court of Appeals drew a distinction between this case and two recent cases in which the Court of Appeals had vacated SEC rules because the SEC "failed to address existing regulatory requirements to determine whether sufficient protections were already present." The Court of Appeals agreed with the district court in holding that, unlike the SEC in the prior two cases cited by the plaintiffs, "the CFTC *did* consider whether [registered investment companies] were otherwise regulated, and concluded that CFTC regulation was necessary" nonetheless. In addition, the court upheld the CFTC's multi-step rulemaking process under which rules will need to be later harmonized with SEC rules. The Court of Appeals noted, however, that although a costs-benefit challenge with respect to harmonization is premature (since, according to the Court of Appeals, it would be "impossible to calculate the costs of an unknown regulation"), the plaintiffs may challenge the costs and benefits of the harmonization rulemaking once such rules are finalized.

The Court of Appeals also rejected the plaintiffs' contention that the particulars of the amendments were arbitrary and capricious. In its opinion the Court of Appeals explained (1) that the Dodd-Frank Wall Street Reform and Consumer Protection Act was amended to include "swaps" in the definitions of CPO and commodity pool (therefore, according to the Court of Appeals, evidencing the importance of swaps), (2) that the plaintiffs' argument regarding the definition of bona fide hedging was "nothing more than [a] policy disagreement with CFTC" and (3) that, under the arbitrary and capricious standard of review, an agency such as the CFTC is entitled to deference with respect to expert determinations such as the 5% threshold. Finally, the Court of Appeals held that the CFTC "gave adequate notice of CFTC's approach to the cost-benefit analysis by setting forth the factors that CFTC would consider and summarizing expected costs and benefits."

- See a copy of the Court of Appeals's opinion

SEC Issues Second-Ever Whistleblower Award

On June 12, 2013, the SEC announced its second-ever "whistleblower" award under Section 21F of the Exchange Act in connection with *SEC v. Andrey C. Hicks and Locust Offshore Management, LLC*, No. 11-cv-11888 (D. Mass. 2011) (the "**Locust Action**"), a 2011 enforcement action in which the SEC charged that Hicks, the purported CEO of an investment advisory firm, lied to prospective investors regarding his education and employment history, created fake offering documents for the adviser's supposed quantitative hedge fund, and lied about the fund's service providers while diverting more than $2.7 million of investor funds to his personal bank accounts.

According to the SEC's Order Determining Whistleblower Claim, three of four anonymous whistleblowers were awarded 15% of the more than $7.5 million in monetary sanctions to which the SEC is entitled pursuant to the judgment in the Locust Action. According to the Order, the SEC Claims Review Staff (the "**CRS**") recommended that the first three claimants each receive a whistleblower award of 5% because two of them voluntarily provided original information to the SEC that helped stop the scheme and led to the successful enforcement of the Locust Action, while another confirmed much of the information and identified key witnesses. According to the Order, a claim for an award by a fourth claimant was denied because the SEC found that the initial tip provided by the claimant regarding securities fraud involving naked shorting was "vague or insubstantial" (and because the information was provided to the SEC prior to July 21, 2010 and was thus not covered by the Section 21F whistleblower provisions). The SEC also did not act on two additional tips that the fourth claimant later submitted because, according to the Order, the tips did not contain information about the ultimate enforcement matter or mention the defendants in the Locust Action, and because the SEC did not make allegations concerning naked short selling. In recommending the claim for an award by the fourth claimant be denied, the CRS explained that the claimant did not lead to the successful enforcement of the Locust Action because the claimant's tips "neither caused the [SEC] to open its investigation nor significantly contributed to the success of the enforcement action."

According to the SEC's announcement of the award, it has not collected any money in connection with the Locust Action (but the Department of Justice has collected approximately $800,000 from Hicks in its related action). According to the SEC's announcement, the whistleblowers entitled to an award under the Locust Action may apply to the SEC to receive their award from the money collected by the Department of Justice.

Dodd-Frank Act Whistleblower Provisions

Section 922 of the Dodd-Frank Act directs the SEC to "pay an award . . . to whistleblowers who voluntarily provide[] original information to the [SEC] that [leads] to" successful enforcement actions and results in monetary sanctions of more than $1 million. Under the Dodd-Frank Act, the size of an award can range from ten to thirty percent of the monetary sanctions that the SEC collects. The Dodd-Frank Act also protects whistleblowers, prohibiting employers from retaliating against them and prohibiting the SEC from disclosing information provided by a whistleblower "which could reasonably be expected to reveal" the whistleblower's identity. For a discussion of the final rules implementing the Dodd-Frank Act's whistleblower provision, please see the May 25, 2011 Davis Polk Client Newsflash, ***SEC Adopts Final Whistleblower Rules***. For a discussion of the SEC's first whistleblower award, please see the August 23, 2012 Davis Polk Client Newsflash, ***SEC Announces First Whistleblower Program Award***.

- See a copy of the SEC's announcement
- See a copy of the 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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