Investment Management Regulatory Update

September 26, 2013

SEC Rules and Regulations

SEC Staff Responds to Questions About Form PF

On August 8, 2013, the Division of Investment Management of the Securities and Exchange Commission (the "**SEC**") issued additional responses (the "**Responses**") to frequently asked questions regarding Form PF. For details on previously posted SEC responses to frequently asked questions regarding Form PF, please see the ***May 16, 2013 Investment Management Regulatory Update***, the ***March 25, 2013 Investment Management Regulatory Update***, the ***December 20, 2012 Investment Management Regulatory Update***, the ***August 22, 2012 Investment Management Regulatory Update*** and the ***July 16, 2012 Investment Management Regulatory Update***.

Investment advisers registered or required to register with the SEC under the Investment Advisers Act of 1940, as amended (the "**Advisers Act**"), that advise one or more private funds (*i.e.*, 3(c)(1) or 3(c)(7) funds) and that have at least $150 million in private fund assets under management ("**private fund advisers**") are required to file Form PF with the SEC for the purpose of reporting systemic risk information to the SEC. Additionally, private fund advisers that are also registered with the Commodity Futures Trading Commission (the "**CFTC**") as commodity pool operators ("**CPOs**") or commodity trading advisors ("**CTAs**") and that are required to file Form PF under the Advisers Act must file Form PF with the SEC to satisfy certain CFTC filing requirements with respect to their commodity pools that are private funds. Such CPOs and CTAs may file Form PF with the SEC to satisfy certain CFTC filing requirements with respect to their commodity pools that are not private funds. Please see the ***November 18, 2011 Investment Management Regulatory Update*** for a discussion of the final Form PF rules and the ***June 19, 2012 Investment Management Regulatory Update*** for a discussion of the initial Form PF deadlines.

The Responses provided guidance on a number of Form PF topics including, among other things:

General Filing Information. The Responses clarified that responses should not be truncated when rounding to the nearest thousand (as required by Instruction 15) when providing monetary value responses. For example, according to the Responses, if the actual monetary value to be reported is $1,111,111, rounding to the nearest thousand would result in reporting a value of $1,111,000 (rather than

$1,111). In addition, the Responses stated that if a private fund adviser must file an other-than-annual amendment to its Form ADV for the sole purpose of being able to add a new private fund to its Form PF report (as required by Instruction 10), such adviser generally need only complete and file Form ADV Section 7.B.1 with respect to the new fund (as opposed to updating all information in Form ADV).

Liquidated Funds. The Responses explained that, if a reporting fund is liquidated during a reporting period, it must nonetheless be included in the private fund adviser's Form PF report for such reporting period. According to the Responses, the private fund adviser should enter "0" or "N/A" for responses that request data as of the reporting date and Question 4 of the Form PF report should indicate that the fund has been liquidated.

Assets and Liabilities. The Responses clarified that assets and liabilities that are not reported at fair value and are therefore not reflected in the fair value hierarchy, such as certain receivables and payables, should be included in the cost-based column in Question 14 using a measurement other than fair value. The Responses further noted that the total amount entered in the assets row of Question 14 should approximate the fund's gross assets reported in Question 8.

Trading and Clearing Mechanisms. The Responses explained that, for Questions 24(b) and 24(c), a private fund adviser may use the gross notional values for reporting the trade volume in respect of options and interest rate derivatives (as opposed to using the delta adjusted notional values for options or 10-year bond equivalents for interest rate derivatives). According to the Responses, in such cases, the private fund adviser should explain in Question 4 that it is using the gross notional values for such options and interest rate derivatives.

Open Positions. The Responses clarified that cash and cash equivalents should not be deemed a "position" for purposes of reporting open positions in response to Questions 35 and 37 and noted that unencumbered cash should be reported in response to Question 33.

Borrowings. The Responses noted that the staff's previously provided guidance for Questions 12 and 43 regarding borrowings also applies to how borrowings should be interpreted for Questions 46 and 47. The prior guidance on the term "borrowings" for purposes of Questions 12 and 43 clarified that "borrowings" include secured borrowings, unsecured borrowings and synthetic borrowings but not leverage embedded through the use of derivatives. Furthermore, the prior guidance provided a non-exhaustive list of the types of borrowings that would be reported: (i) short sales (and, according to the prior guidance, the value of a borrowing through selling a security short is the "value that is reported internally and to current and prospective investors of the fund that is selling the security short"), "(ii) securities lending transactions, (iii) reverse repurchase agreements, (iv) transactions in which variation margin is owed, but as a result of not reaching a certain set threshold, has not been paid by a fund, or (v) transactions involving synthetic borrowings (*e.g.*, total return swaps that meet the failed sale accounting requirements)."

- **See a copy of the Responses**

SEC, FINRA and CFTC Release Joint Observations Regarding Business Continuity Plans

On August 16, 2013, the SEC, the Financial Industry Regulatory Authority ("**FINRA**"), and the CFTC's Division of Swap Dealers and Intermediary Oversight jointly published best practices and "lessons learned" regarding business continuity plans ("**BCPs**" and such publication, the "**BCP release**") and disaster recovery procedures. According to the SEC, FINRA and the CFTC, the BCP release was published in response to the events affecting the market and firms as a result of Hurricane Sandy, and the best practices and lessons learned were developed from information gathered by the regulators from firms with a significant market presence that were impacted by events resulting from Hurricane Sandy.

According to the BCP release, the SEC, FINRA and the CFTC suggest that firms review their BCPs and consider implementing certain best practices including, among other things, the following:

- **Widespread Disruption Considerations**. In the event of a widespread disruption in the availability of telecommunications, transportation, electricity, office space, fuel or water, firms should consider whether a plan is in place to ensure that adequate staffing is available to continue the business and whether employees (and, in particular, key employees) have the ability to work from home. In addition, according to the BCP release, firms should considering identifying technology, products and services that would enhance employees' ability to work from home.
- **Alternative Locations Considerations**. In the event of a region-wide crisis, a firm should consider whether alternative locations (*e.g.*, operations back-up sites and remote office locations) are geographically diverse from the firm's main location. In addition, a firm should consider whether alternative locations have adequate space, resources and accessibility. According to the BCP release, firms should consider whether employees would have the ability to travel to an alternative location and consider pre-arranging shuttle or other travel services and hotel, lodging and office space in anticipation of a region-wide event.
- **Vendor Relationships**. According to the BCP release, firms should consider whether third-party vendors that provide critical services (*e.g.*, clearing and settlement, banking, utility and delivery services) have adequate BCPs to minimize the disruption impacting firms. In addition, a firm should consider whether such vendors are likely to be impacted by the same crises that would affect the firm (*e.g.*, because of similar geographic locations) and also consider identifying such vendors as high, medium or low risk in the firm's BCP.
- **Telecommunications Services and Technology Considerations**. Firms should consider having relationships with multiple telecommunications providers (*e.g.*, telephone, internet, mobile communications device service providers) in the event that one particular provider is impacted by the same crisis affecting the firm and consider whether employees working remotely during a crisis would be fully functional with respect to such services.
- **Communication Plans**. Firms should seek to ensure that they can communicate and continue their businesses with customers and counterparties and consider implementing a plan to communicate with regulators, exchanges and emergency officials. According to the BCP release, a firm should indicate its operational status on its website during a crisis event.
- **Regulatory and Compliance Considerations**. Firms should ensure that they can comply with regulatory requirements during a crisis event (including, *e.g.*, month-end financial processes) and ensure that BCPs are updated with any recently implemented regulatory requirements applicable to the firm (*e.g.*, according to the BCP release, in 2012 the Chicago Mercantile Exchange and National Futures Association adopted new daily reporting requirements of financial data that were not reflected in some firms' BCPs, which led to such requirements not being properly prioritized during Hurricane Sandy).
- **Review and Testing**. Firms should test their BCPs at least annually to evaluate their ability to operate during a crisis event and should conduct training to ensure that employees understand crisis event procedures and expectations.

► **See a copy of the BCP release**

SEC Staff Expands Relief for "Privately Offered Securities" Under the Custody Rule

On August 1, 2013, the Division of Investment Management of the SEC issued an IM Guidance Update to inform registered investment advisers ("**RIAs**") to audited private funds that, if certain conditions are met, as discussed below, RIAs would not be required to maintain so-called "private stock certificates" (*i.e.*, "non-transferrable stock certificates or 'certificated' LLC interests" acquired in private placements) with a qualified custodian. Rule 206(4)-2 under the Advisers Act (the "**Custody Rule**") generally requires an RIA with custody of a fund's assets to maintain the fund's assets with a "qualified custodian" in a separate account in the fund's name (or in accounts that contain only the RIA's clients' assets), unless the privately offered securities exception is met. The privately offered securities exception, in the case of a private fund client, requires that (1) the fund's financial statements be audited by an independent public accountant that is registered with and subject to regular inspection by the Public Company Accounting Oversight Board ("**PCAOB**") and (2) the securities in question be "privately offered securities"—meaning (A) the securities were not acquired through a public offering; (B) the securities are uncertificated and have their ownership recorded only on the books of the issuer or its transfer agent in the name of the client and (C) the securities may be transferred only with prior consent of the issuer or holders of the issuer's securities. According to the IM Guidance Update, because private stock certificates do not meet (2)(B) above, they do not satisfy the conditions of the privately offered securities exception. Nonetheless, according to the IM Guidance Update, the Division would not object if an RIA does not maintain private stock certificates with a qualified custodian, provided that:

- the client is a fund subject to a financial statement audit in accordance with the "audit provision" of the Custody Rule, which requires the fund to be subject to an annual audit by an independent public accountant that is registered with and subject to regular inspection by the PCAOB, and the audited financial statements to be provided to all beneficial owners of the fund on an annual basis generally within 120 days of the end of the fund's fiscal year;
- the private stock certificate may be transferred (or otherwise effect a change of beneficial ownership) only with prior consent of the issuer or holders of the issuer's securities;
- the ownership of the private stock certificate is recorded on the books of the issuer or its transfer agent in the name of the client;
- the private stock certificate has a legend that restricts transfer; and
- the RIA appropriately safeguards the private stock certificate and the private stock certificate can be replaced if lost or destroyed.

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

Industry Update

CFTC Adopts Final Harmonization Rule for CPOs of Registered Investment Companies

On August 13, 2013, the CFTC adopted final regulations designed to harmonize the obligations of registered CPOs under the CFTC Part 4 Regulations for commodity pools that are registered as investment companies ("**RICs**") under the Investment Company Act of 1940 ("**Investment Company Act**") with the obligations applicable to RICs under the Investment Company Act and other securities laws. The final regulations also amend several Part 4 obligations as they apply to all registered CPOs with respect to all types of commodity pools.

In a significant departure from the harmonization rules proposed by the CFTC in February 2012, as discussed in the ***March 21, 2012 Investment Management Regulatory Update***, the final regulations adopt a "substituted compliance" framework that permits a registered CPO of a RIC to comply with the disclosure, reporting and recordkeeping requirements applicable to the RIC under the Securities Act of 1933, the Investment Company Act and regulations of the SEC in lieu of complying with many of the analogous Part 4 requirements that would otherwise apply to the registered CPO. Such substituted compliance is available under the final regulations for some, but not all, Part 4 requirements. Thus, while the harmonization rules provide important relief for registered CPOs of RICs with respect to most Part 4 compliance obligations, the rules do not address all requirements with which registered CPOs must comply. For example, the harmonization rules do not address requirements for registered CPOs under National Futures Association bylaws. In addition, the harmonization rules do not affect the applicability of

CFTC rules governing commodity interest trading activities, such as position limits or new swap regulatory requirements. Therefore, registered CPOs should carefully review their compliance programs in light of the harmonization rules to ensure they are meeting all applicable requirements.

Contemporaneously with the CFTC's adoption of the harmonization rules, the SEC's Division of Investment Management issued an IM Guidance Update that provides a summary of the Division's views on the disclosure obligations of an investment adviser to a RIC that trades in commodity interests, including futures and swaps, and on related compliance issues.

For further discussion of the CFTC's final harmonization rules and certain aspects of the IM Guidance Update that should be considered by registered CPOs in implementing any new obligations applicable to them under the harmonization rules, please see the September 9, 2013 Davis Polk Client Memorandum, ***CFTC Adopts Final Harmonization Rule for Commodity Pool Operators***.

- **See a copy of final harmonization rules**
- **See a copy of the IM Guidance Update**

Litigation

SEC Charges Investment Adviser and Its Former Owner with Misleading Mutual Fund Directors

On August 21, 2013, the SEC charged Chariot Advisors LLC ("**Chariot Advisors**"), a registered investment adviser, and Elliott L. Shifman, Chariot Advisors' former owner, with misrepresenting its investment objective to the board of directors of a registered investment company (the "**Fund**"). The SEC alleged that in 2008 Shifman made a presentation to the Fund's board of directors to seek approval of an advisory contract for Chariot Advisors to serve as the Fund's investment adviser. According to the SEC, Shifman misled the Fund's board by stating that Chariot Advisors' investment objective would include using 20% of the Fund's assets under management to engage in currency trading using an algorithmic trading model. According to the SEC, contrary to Shifman's representations to the Fund's board, Chariot Advisors had not developed and did not otherwise possess any such algorithms. The SEC alleged that after the advisory contract was approved by the Fund's board, but prior to the Fund's launch, Shifman transferred his interest in Chariot Advisors, which led the Fund's board to require the advisory contract be re-approved. The SEC alleged that Shifman again presented to the Fund's board and claimed that an algorithmic trading model would be employed. According to the SEC, the advisory contract was again approved by the Fund's board, but for at least two months after the Fund had been launched, rather than use an algorithmic trading model, Chariot Advisors relied on the discretion of an individual trader to engage in currency trading, which was contrary to the representations made to the Fund's board (and contrary to the disclosure in the Fund's registration statement). The SEC alleged that less than three months after the Fund had been launched, the individual trader was terminated due to poor performance, and a third party was hired to conduct currency trading for the Fund using an algorithmic model.

Based on such conduct, the SEC charged Chariot Advisors with violating (and Shifman with aiding and abetting Chariot Advisors' violations of) Section 15(c) of the Investment Company Act, which requires an investment adviser to a registered investment company (a "**RIC**") to provide the RIC's board of directors with information reasonably necessary to evaluate and approve an investment advisory contract (the so-called "15(c) process"). In addition, the SEC charged Chariot Advisors with violating (and Shifman with aiding and abetting Chariot Advisors' violations of) Section 34(b) of the Investment Company Act, which, among other things, makes it unlawful to make an untrue statement of material fact in a registration statement, and Sections 206(1) and 206(2) of the Advisers Act, which prohibit fraudulent conduct by an investment adviser. Finally, the SEC charged Chariot Advisors with violating Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder, which generally prohibit an investment adviser to a fund from making misleading statements or omitting to state a material fact to investors or prospective investors of a fund.

The SEC noted in its press release that the charges arose out of an initiative by the SEC to focus on procedures related to the 15(c) process and referenced two prior cases that also arose under the initiative, which have been discussed in the ***December 7, 2011 Investment Management Regulatory Update*** and the May 13, 2013 Davis Polk Client Memorandum, ***The SEC's Northern Lights Enforcement Action: Implications for Fund Directors***.

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

Notes from Europe: European Regulatory Developments

Editor's Note: With this month's publication, we are launching Notes from Europe: European Regulatory Developments, a new, regular section of the Investment Management Regulatory Update that will discuss significant regulatory developments in Europe that affect the investment management industry. The primary author of this section is Richard Small, who recently joined Davis Polk as regulatory counsel in our London office. Richard focuses on advising financial institutions on European and U.K. financial regulatory law matters, including market abuse, the pan-European short selling regime and the Alternative Investment Fund Managers Directive. He works closely with our Investment Management Group, advising alternative investment fund managers and other investment advisers on a wide variety of regulatory issues.

The Appointment of Delegates Under AIFMD

The Alternative Investment Fund Managers Directive ("**AIFMD**"), which became effective on July, 22, 2013, not only represents a sea change in the regulation of fund managers established in Europe, but also has significant effects on fund managers outside of Europe. Much has already been written in relation to the restrictions on the marketing of alternative investment funds by non-EU managers to EU-based investors, but another aspect of AIFMD that has received less attention, but which has a material impact on non-EU managers, is the appointment of delegates, both where an EU manager seeks to appoint a non-EU delegate and where a non-EU manager seeks to appoint an EU delegate.

Two key issues arise in relation to the appointment of a delegate. First, particular care should be taken in appointing a delegate to ensure that the appointing entity is not re-characterized by the relevant regulator as being a "letter-box entity." Such re-characterization would result in the delegate being deemed to be the manager of the fund, which could, depending on the location of the delegate, require it to become authorized by the relevant regulator. Second, one potential interpretation of the European Securities Markets Authority's February 2013 Guidelines on remuneration policies under AIFMD could be that where an EU manager delegates the portfolio or risk management functions, it is also obliged to impose on the delegate the same requirements in relation to remuneration to which the manager is subject.

Davis Polk has recently published an article in *The Hedge Fund Journal* examining some of the key elements of the new regime under AIFMD relevant to the appointment of delegates and focuses on the practical implications both for non-EU managers and non-EU delegates.

- **See a copy of our article in the August 2013 issue of The Hedge Fund Journal**

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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