Investment Management Regulatory Update

October 22, 2013

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SEC Rules and Regulations

SEC Focused on Violations of Rule 105 of Regulation M

On September 17, 2013, the Securities and Exchange Commission (the "**SEC**") announced the settlement of charges against 22 of 23 firms that were recently charged with violating Rule 105 of Regulation M ("**Rule 105**"). Rule 105 generally prohibits a person from selling an equity security short within the Rule 105 "restricted period" (generally five business days before the pricing of such equity securities in connection with a follow-on or secondary offering and lasting until the end of such pricing) and then purchasing the equity security in such follow-on or secondary offering, unless an exemption is available. Notably, a violation of Rule 105 does not require intent on the part of a trader who sells short and subsequently purchases in a public offering within the restricted period. According to its press release, the SEC has increased its focus on preventing Rule 105 violations. Simultaneously with the SEC's announcement, the staff of the SEC's Office of Compliance Inspections and Examinations issued a National Examination Risk Alert (the "**Alert**") focused on deficient practices observed by the SEC's National Examination Program ("**NEP**") staff related to violations of Rule 105. According to the Alert, since January 2012, the SEC has settled over 40 Rule 105-related enforcement actions and has collected disgorgement, penalties and interest in excess of $42 million based on such Rule 105-related enforcement actions.

According to the Alert, the NEP staff has identified among firms that have been examined certain deficient practices relating to Rule 105, including (1) a lack of training on Rule 105 for employees of firms and (2) inadequate implementation and enforcement of compliance policies and procedures reasonably designed to "identify, mitigate and manage risks involving short sales in connection with follow-on or secondary

offerings." The Alert also noted that, in assessing penalties for Rule 105 violations, the SEC has considered whether, after detecting a Rule 105 violation, violating firms had implemented remedial efforts, such as compliance policies, procedures and controls to prevent future violations.

- See a copy of the SEC's press release
- See a copy of the Alert

IM Director Discusses Current Priorities Regarding Hedge Fund Managers

On September 12, 2013, in a speech at the PLI Hedge Fund Management Conference, Norm Champ, Director of the SEC Division of Investment Management, discussed, among other things, his views on the SEC's current priorities regarding private managers, including in relation to the recent changes made to the private placement exemptions.

Changes to Rule 506 of Regulation D. On July 10, 2013, in separate releases, the SEC adopted final rules (which became effective on September 23, 2013) (1) to permit widespread advertising and other forms of "general solicitation" in private offerings made in reliance on Rule 506, so long as all purchasers in the offering are accredited investors and (2) that disqualify securities offerings involving certain felons and other "bad actors" from reliance on Rule 506. For a further discussion of these changes, please see the July 29, 2013 Davis Polk Client Newsflash, ***Private Offering Reform: Analysis and Implications***.

In connection with the elimination of the prohibition on general solicitation in offerings made in reliance on Rule 506, Champ cautioned that advisers to private funds remain subject to the anti-fraud rules that prohibit fraudulent and misleading conduct (such as untrue statements of material fact made in soliciting investors). Champ noted that private fund advisers (especially if advisers expect to use general solicitation to offer securities in reliance on Rule 506) should carefully review, and, if necessary, update, their policies and procedures as they relate to preventing the use of misleading advertising. According to Champ, private fund managers intending to use general solicitation should also consider whether their current practices for verifying accredited investor status meet the "reasonable steps" verification standards set forth in the new rule. Additionally, Champ announced that the SEC has established an inter-Divisional group to review the Rule 506 market as it relates to the use of general solicitation, which will include an evaluation of the types of accredited investor verification practices being employed by issuers. Champ further stated that he has instructed the SEC's Division of Investment Management rulemaking and risk and examination staff to "pay particular attention to the use of performance claims in the marketing of private fund[s]." With regard to the new Rule 506 "bad actor" provisions, Champ noted that the SEC has received interpretive questions that are currently being evaluated by SEC staff, which could result in the issuance of guidance.

Form PF. Champ also discussed the improved information on the private fund industry that the SEC has collected from Form PF, which, according to Champ, may be used to develop analytics that would provide the staff with research and due diligence tools in connection with SEC examinations and enforcement matters.

Advisers Act. Champ noted that the SEC is reviewing the rules under the Investment Advisers Act of 1940 (the "**Advisers Act**") and is considering whether the "rules require modernization to reflect the current business and operations of private fund advisers." Champ acknowledged that the SEC's evaluation of (and any potential rulemaking related to) the Advisers Act would be a time-intensive process. Meanwhile, according to Champ, the Division intends to actively consider providing guidance on the Advisers Act, as appropriate, and referenced recent guidance the Division issued in respect of the custody rule, as was discussed in the ***September 26, 2013 Investment Management Regulatory Update***.

Insider Trading. Champ encouraged advisers to private funds to evaluate their policies and procedures to determine whether they are reasonably designed to prevent the misuse of material non-public

information and also to ensure that employees are properly trained on the firm's insider trading policies and procedures.

- See a copy of Champ's speech

SEC Staff Provides Guidance to BDCs Regarding Summarized Financial Statements of Subsidiaries

In September 2013, the Division of Investment Management of the SEC issued an IM Guidance Update to inform business development companies ("**BDCs**") that it would not recommend enforcement action if a BDC that is required, pursuant to Rule 4-08(g) under Regulation S-X, to present summarized financial information in the notes to its financial statements for all of its unconsolidated subsidiaries, instead only presents summarized financial information for each unconsolidated subsidiary that meets the definition of "significant subsidiary" in Rule 1-02(w) under Regulation S-X.

In filing a Form N-2, BDCs are instructed to "comply with the provisions of Regulation S-X generally applicable to registered management investment companies." As it relates to the filing of financial statements of BDCs, Regulation S-X requires BDCs to follow Rules 3-09 and 4-08(g) thereunder. Rule 3-09 generally describes "the circumstances under which separate financial statements of an unconsolidated majority-owned subsidiary are required to be filed." Rule 4-08(g) generally requires BDCs to "present in the notes to their financial statements summarized financial information for all unconsolidated subsidiaries when any unconsolidated subsidiary, or combination of unconsolidated subsidiaries, meets the definition of a 'significant subsidiary.'"

According to the IM Guidance Update, the guidance provided by the staff is consistent with the comments that the staff has provided to BDCs in connection with the review of registration statements of BDCs that have significant subsidiaries, but failed to provide separate financial statements or summarized financial information for such subsidiaries.

According to the IM Guidance Update, a BDC should contact the staff if it believes that "the application of Rule 3-09 or Rule 4-08(g) [would] result[] in the presentation of either financial statements or summarized financial information of an unconsolidated subsidiary that is not necessary to reasonably inform investors . . . ."

- See a copy of the IM Guidance Update

SEC Releases Final Municipal Advisor Registration Rules

On September 18, 2013, the SEC adopted a final rule (the "**Final Rule**") establishing a permanent registration scheme to replace the temporary registration scheme for municipal advisors that has been in effect since October 2010. As discussed in the October 2, 2013 Davis Polk Client Memorandum, ***SEC Releases Final Municipal Advisor Registration Rules – Part I: Who is a Municipal Advisor?***, the Final Rule provides detailed guidance regarding who must register as a municipal advisor, and applicable exemptions. For a detailed discussion of the mechanics and timing of permanent registration for those required to register as a municipal advisor, please see the October 7, 2013 Davis Polk Client Memorandum, ***SEC Releases Final Municipal Advisor Registration Rules Part II: Permanent Registration Process***.

- **See a copy of the Final Rule**

Industry Update

CFTC Provides No-Action Relief from Certain Reporting Obligations for CPOs of Controlled Foreign Corporations Wholly-Owned by Registered Investment Companies

On September 5, 2013, the Division of Swap Dealer and Intermediary Oversight (the "**Division**") of the Commodity Futures Trading Commission (the "**CFTC**") issued CFTC Letter No. 13-51 (the "**No-Action Letter**"), which grants relief from certain reporting requirements under Part 4 of the CFTC's Regulations (the "**Regulations**") that are applicable to commodity pool operators ("**CPOs**") of registered investment companies ("**RICs**") that use wholly-owned controlled foreign corporations ("**CFCs**") to trade in commodity interests.

As discussed in the September 9, 2013 Davis Polk Client Memorandum, ***CFTC Adopts Final Harmonization Rules for Commodity Pool Operators***, on August 13, 2013, the CFTC adopted final regulations (the "**harmonization rules**") designed to harmonize the compliance obligations of registered CPOs under the Regulations for commodity pools that are RICs with the obligations applicable to RICs under the Investment Company Act of 1940 (the "**Investment Company Act**"), and other securities laws. The harmonization rule release and the No-Action Letter state that, depending on its commodity interest trading activities, a CFC may be considered a separate commodity pool from its parent RIC and that, absent an exclusion or exemption, the CPO of such a CFC may be required to comply with the Regulations as they apply to the CFC.

Relief from CFTC Regulation 4.27(c). Regulation 4.27(c) generally requires that a registered CPO file with the National Futures Association (the "**NFA**") a report on Form CPO-PQR for each pool that it operates. The Investment Company Institute has sought confirmation from the Division that, following the adoption of the final harmonization rules, CPOs of RICs must begin reporting on Form CPO-PQR beginning with the reporting period ending December 31, 2013. Although the Division has yet to confirm that this will be the first applicable reporting period, the No-Action Letter states that the Division will not recommend enforcement action against the CPO of a RIC that uses a wholly-owned CFC to trade commodity interests for failing to file a report on Form CPO-PQR with the NFA for such CFC if, when required to begin filing for the RIC, the CPO provides to the NFA a consolidated report on Form CPO-PQR for the RIC that also contains data for the CFC. To claim the relief, the CPO must either (1) consolidate the RIC's and CFC's financial statements for financial reporting purposes or (2) be in the process of moving to consolidated reporting for the RIC and CFC and (a) operate at least one RIC that currently consolidates its financial statements with its CFC and (b) consolidate the financial statements of its other RICs with their CFCs as of the filing made for the first applicable reporting period.

Relief from CFTC Regulation 4.22(c). Regulation 4.22(c) generally requires that a registered CPO deliver a certified annual report (which generally requires certain financial information related to the pool) to each participant of a pool operated by such CPO and to submit a copy of the annual report to the NFA. According to the No-Action Letter, under Regulation 4.22(c)(8), a CFC is not required to provide a copy of such report to its parent RIC; however, absent further relief, the Regulations would require a CPO of a RIC that uses a wholly-owned CFC to trade commodity interests to file an annual report for the CFC with the NFA. According to the No-Action Letter, the Division will not recommend enforcement action against such a CPO if the CPO does not submit separately an annual report in respect of a CFC to the NFA, if the CPO (1) prepares an annual report for the RIC that has consolidated audited financial statements for the RIC, but also has the relevant financial statement amounts that relate to the CFC separately indicated and (2) submits such an annual report to the NFA (in lieu of a separate report for the CFC) for the next fiscal year of the RIC that ends after October 21, 2013.

According to the No-Action letter, the relief is only available to the CPO of a CFC that is also the CPO of the CFC's parent RIC. The relief is not self-executing; an eligible CPO must file a claim for relief (which is

automatically effective if materially complete) prior to the end of the RIC's next fiscal year following October 21, 2013.

- See a copy of the No-Action Letter

Litigation

SEC Charges Former Portfolio Manager with Misleading Chief Compliance Officer

On August 27, 2013, the SEC charged Carl Johns, the former portfolio manager of a Colorado-based investment adviser to several registered investment companies, for failing to pre-clear personal trades, forging documents to hide his misconduct and misleading the adviser's chief compliance officer (the "**CCO**"). According to the SEC's press release, the charges were the SEC's first enforcement action brought under Rule 38a-1(c) of the Investment Company Act, which prohibits a person from "directly or indirectly tak[ing] any action to coerce, manipulate, mislead, or fraudulently influence [a] fund's chief compliance officer. . . ."

According to the SEC, from 2006 through 2012, Johns executed approximately 850 personal trades. The SEC alleged that Johns failed to pre-clear or report approximately 640 of his trades (including 91 trades in securities of companies that the funds managed by the adviser held or later acquired), as required by the adviser's code of ethics. In addition, the SEC alleged that Johns attempted to conceal his personal trading by creating false quarterly and annual reports and also altered (and in some cases forged) the adviser's pre-clearance approvals, brokerage statements and trade confirmations to reflect that he had complied with the adviser's policies and procedures, when, in fact, he had not.

According to the SEC, when the adviser's CCO questioned Johns about irregularities in the firm's documents relating to Johns' personal securities transactions, Johns misled the CCO by stating that his brokerage accounts had been closed (when in truth they remained open and included trades that had not been pre-cleared).

Based on such conduct, the SEC found that Johns willfully violated (1) Section 17(j) of the Investment Company Act, which generally prohibits a person affiliated with a registered investment company (a "**RIC**") from engaging in any act, practice or course of business, in connection with buying or selling securities that are held (or to be acquired) by the RIC, that violates the SEC's anti-fraud rules, (2) Rule 17j-1(b) under the Investment Company Act, which, among other things, prohibits RIC-affiliated persons from, in connection with buying or selling securities that are held (or to be acquired) by the RIC, from making any untrue statements of material fact to the RIC (or omitting to state a material fact so as to not mislead the RIC), (3) Rule 17j-1(d) under the Investment Company Act, which generally requires certain employees of and other persons affiliated with a RIC to report personal securities transactions on a quarterly basis and to report securities holdings on an annual basis and (4) Rule 38a-1(c) under the Investment Company Act.

Without admitting or denying the SEC's findings, Johns consented to a five-year ban from the securities industry. The SEC ordered Johns to cease and desist from future violations of the relevant provisions of the Investment Company Act, and ordered Johns to pay disgorgement of $231,169 (plus prejudgment interest of $23,889) and a civil penalty of $100,000.

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

Notes from Europe: European Regulatory Developments

UK AIFMD Remuneration Code Disapplication

In September 2013, the UK Financial Conduct Authority (the "**FCA**") launched a consultation on the application of the principle of proportionality to the rules on the remuneration payment process (payment in instruments, deferral, vesting, etc.) to partners or members of a full-scope UK alternative investment fund manager ("**AIF Manager**") that is established as a partnership or limited liability partnership. A "full-scope" UK AIF Manager is an AIF Manager that has its registered office in the UK, is authorized in the UK and is not considered to be a small authorized UK AIF Manager. Please see the August 8, 2013 Davis Polk Client Memorandum, ***European Regulatory Snapshot: Remuneration in the Financial Services Industry*** for further details of the remuneration restrictions under the Alternative Investment Fund Managers Directive ("**AIFMD**").

The FCA proposes that based on the net amount of alternative investment fund ("**AIF**") assets that an AIF Manager has under management, certain remuneration requirements be disapplied on the grounds of proportionality. Ultimately, the FCA will consider a number of factors, such as whether the AIF Manager is listed and traded on a regulated market, any portfolio or risk management delegation arrangements that it has in place and the nature of certain fee structures, such as carried interest, in addition to the thresholds, when determining whether the remuneration requirements should be disapplied.

The threshold ranges (the final guidance will have a single threshold that will be determined based on the results of the consultation) for the disapplication of the remuneration requirements are as follows:

- for AIF Managers that manage portfolios of AIFs that include assets acquired through leverage – less than between £500 million and £1.5 billion; and
- for AIF Managers that manage portfolios of AIFs that are unleveraged and have no redemption rights during the first five years – less than between £4 billion and £6 billion.

The guidance will be open for consultation until November 6, 2013. The FCA expects to publish its final guidance no later than early 2014, with a view to firms developing an appropriate remuneration policy before the end of the AIFMD transitional period, which ends on July 22, 2014.

- See a copy of the FCA's Quarterly Consultation No. 2

European Parliament Proposes Regulation on European Long-Term Investment Funds

In October 2013, the European Parliament indicated that it will consider the proposed regulation on European long-term investment funds ("**ELTIFS**" and such regulation, the "**ELTIF Regulation**") in its plenary session to be held from February 3, 2014 through February 6, 2014. The ELTIF Regulation will come into force shortly after adoption, if it is adopted by the European Parliament. The ELTIF Regulation, which was initially proposed by the European Commission in June 2013, establishes a new type of collective investment fund framework that will allow individual and institutional investors to invest in companies and projects for the long term (ELTIFs would only be allowed to invest in businesses that need money to be committed to them for long periods of time). Funds designated as ELTIFs will be able to market themselves across the EU under a cross-border passport. Unlike UCITS funds, however, investors will not be able to get their money back at any time.

Only EU AIFs managed by AIF Managers that are authorized and have their registered office in the EU would be eligible to become authorized ELTIFs and use the ELTIF designation. In addition, ELTIFs will be subject to a number of requirements and restrictions, including:

- the requirement to appoint a depositary for the safekeeping of assets;

- restrictions on the types of assets that they can be invested in and a requirement that ELTIFs invest at least 70% of the money in the fund in such assets;
- the requirement to comply with rules on portfolio diversification to prevent the fund from being too concentrated in any one asset;
- that the use of derivatives would be restricted to managing foreign exchange risks in connection with the assets held by the fund;
- limits on the amount that an ELTIF can borrow; and
- that ELTIFS must be operated for a specified period of time before investors would have the right to get their money back (such liquidity restrictions are required to be clearly explained to investors).

▸ See a copy of the proposed ELTIF Regulation

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.

John G. Crowley	**212 450 4550**	**john.crowley@davispolk.com**
Nora M. Jordan	**212 450 4684**	**nora.jordan@davispolk.com**
Yukako Kawata	**212 450 4896**	**yukako.kawata@davispolk.com**
Leor Landa	**212 450 6160**	**leor.landa@davispolk.com**
Gregory S. Rowland	**212 450 4930**	**gregory.rowland@davispolk.com**
Richard Small	**+44 20 7418 1379**	**richard.small@davispolk.com**
Robert F. Young	**212 450 4709**	**robert.young@davispolk.com**

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