Investment Management Regulatory Update

December 20, 2013

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SEC Rules and Regulations

Regulators Adopt Final Regulations Implementing the Volcker Rule

On December 10, 2013, the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Securities and Exchange Commission (the "**SEC**") and the Commodities Futures Trading Commission adopted final regulations implementing the Volcker Rule. The Dodd-Frank Act required these five regulators to consult and adopt rules restricting the ability of banking entities (i) to engage in proprietary trading and (ii) to invest in, sponsor or enter into certain transactions with hedge funds or private equity funds.

As Davis Polk continues to analyze the final rule, we have created a **collection of reference materials** that we believe may prove helpful. The page is part of Davis Polk's Volcker Rule resource site, **volckerrule.com**, where we will provide updates to our proprietary trading and hedge/PE fund visual memoranda, information on **forthcoming compliance tools**, and other materials.

The final rules become effective on April 1, 2014. The Federal Reserve Board has extended the conformance period until July 21, 2015.

SEC Releases Rule 506 "Bad Actor" Guidance

On December 4, 2013, the SEC's Division of Corporate Finance issued Compliance and Disclosure Interpretations ("**C&DIs**") regarding the "bad actor" rules adopted by the SEC, which generally disqualify securities offerings involving certain felons and other "bad actors" from reliance on Rule 506 of Regulation D. The rules are codified as Rules 506(d)–(e) under the Securities Act of 1933, as amended (the "**Securities Act**"), and became effective on September 23, 2013. Under Rule 506(d), if one of an enumerated list of covered persons in relation to an offering of securities is subject to a "disqualifying

event" that occurred on or after September 23, 2013, then the issuer is generally disqualified from relying on Rule 506. In addition, pursuant to Rule 506(e), if a covered person is subject to a matter that would have been a disqualifying event had it occurred on or after September 23, 2013, then the issuer must furnish to each purchaser, a reasonable time prior to selling securities in reliance on Rule 506, written disclosure of such matter.

Please see the December 11, 2013 Davis Polk Client Memorandum, ***SEC Issues Guidance on Rule 506 "Bad Actor" Provisions***, for a discussion of the guidance and interpretations on certain key aspects of the bad actor rules that affect investment advisers and the funds they manage.

- **See a copy of the C&DIs**
- **See a copy of the Adopting Release for Rules 506(d)-(e)**

IM Guidance Update Cautions Against Use of Fund Names Suggesting Protection From Loss

In November 2013, the SEC's Division of Investment Management issued an IM Guidance Update regarding the use of names by funds that suggest safety or protection from loss.

According to the IM Guidance Update, upon reviewing fund disclosure materials, the SEC staff has recently requested that certain funds change their names to prevent such funds' names from causing investors to misunderstand the potential for loss associated with an investment in the fund. In the IM Guidance Update, the staff specifically highlighted the use of the terms "protected" or "guaranteed," or similar terms, and stated that when used in a fund name without additional qualifications that would sufficiently describe the scope of protection offered by a fund, such terms may contribute to investor misunderstanding.

Furthermore, the staff noted in the IM Guidance Update that in cases where, pursuant to a contractual arrangement, a third party has agreed to cover a shortfall in a fund's net asset value ("**NAV**"), a fund's name should not include terms such as "protection" or other terminology that may suggest safety of assets, "unless the name adequately communicates the limitations of [such] 'protection.'" According to the IM Guidance, examples of the limitations of protection in such circumstances include the amount the third party is be obligated to cover under the terms of the contract, the applicable term of the contract, any termination provisions of the contract and the credit risk associated with the third party responsible for covering any shortfall.

According to the IM Guidance Update, in observing cases where a third party was obligated to cover a shortfall in a fund's NAV and where such fund's name suggested safety or protection, the staff had not yet encountered any fund names that also included terminology that sufficiently tempered the implications suggested by the name. In addition, the staff emphasized that disclosure in a fund's offering document on the limitations of the scope of any protection is not necessarily sufficient to offset the use of a name that suggests safety or protection without also including in the name terminology to address limitations in protection.

According to the IM Guidance Update, the staff encourages fund sponsors to evaluate whether a fund's name could lead to investor misunderstanding about the nature and limits of a funds' protection, and, if so, consider changing the fund's name, as appropriate.

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

Litigation

SEC Enters into First-Ever Deferred Prosecution Agreement with an Individual

On November 12, 2013, the SEC announced that it entered into a five-year Deferred Prosecution Agreement (the "**DPA**") with Scott Herckis ("**Herckis**"), the former fund administrator for Heppelwhite Fund LP (the "**Fund**") – a hedge fund that was managed by Berton M. Hochfeld ("**Hochfeld**"), who, according to the DPA, was charged in 2012 with securities fraud for misappropriating more than $1.5 million from the Fund. According to the SEC's press release, the DPA is the first deferred prosecution agreement that the SEC has reached with an individual since the SEC's Division of Enforcement announced the "Cooperation Initiative" in 2010 to facilitate and reward cooperation in SEC investigations.

According to the DPA and the SEC's press release, Herckis served as administrator of the Fund from 2010 to 2012. The SEC alleged that, during such time, Herckis, as the Fund's administrator, would transfer Fund assets to the Fund's general partner (which was controlled by Hochfeld) at Hochfeld's instruction, including during times when the general partner's Fund capital account was already overdrawn. In addition, the SEC alleged that Herckis prepared and provided materially overstated account statements to Fund investors and rate of return information to potential investors. Furthermore, according to the DPA, Herckis's calculation of the Fund's net asset value ("**NAV**") was materially higher than the NAV reported by the Fund's prime broker. According to the DPA, in September 2012, Herckis resigned as administrator to the Fund and contacted government authorities because of his concerns over the Fund's general partner's negative capital account and because he could not reconcile the discrepancy between his NAV calculation and the prime broker's reported NAV. According to the DPA, Herckis "voluntarily provided immediate and complete cooperation" in the SEC's subsequent investigation of Hochfeld, which resulted in an emergency action against Hochfeld and the freezing of more than $6 million of assets owned by the Fund, its general partner and Hochfeld that are intended to pay back Fund investors.

Based on such conduct, the SEC alleged that Herckis aided and abetted Hochfeld's violations of Section 17(a) of the Securities Act, Section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 thereunder, and Sections 206(1), (2) and (4) of the Investment Advisers Act of 1940 (the "**Advisers Act**") and Rule 206(4)-8 thereunder. Under the DPA, the SEC agreed not to prosecute Herckis in a civil action for five years, provided that Herckis refrains from violating federal and state securities laws during such period and Herckis (i) does not serve as a fund administrator or provide any services to any hedge fund during such period and (ii) does not associate with or work for certain securities industry participants (e.g., a broker, dealer, investment adviser or registered investment company) during such period. According to the DPA, Herckis agreed to pay $48,000 in disgorgement and $2,290 in prejudgment interest. In addition, according to the DPA, during the five-year deferred prosecution period, Herckis agreed to perform a number of undertakings designed to prevent future violations of the securities laws and violations of the DPA.

- **See a copy of the SEC Press Release**
- **See a copy of the Deferred Prosecution Agreement**

SEC Charges Money Market Fund Manager with Deceiving the Fund's Board and Failing to Comply with Risk-Limiting Rules

On November 26, 2013, the SEC charged Ambassador Capital Management, LLC ("**Ambassador**"), a Detroit-based investment adviser that is registered with the SEC, and Derek H. Oglesby ("**Oglesby**"), a portfolio manager who was employed by Ambassador and who was primarily responsible for managing Ambassador Money Market Fund (the "**Fund**"), with making false statements to the board of trustees of the Fund regarding the credit risk of the securities held by the Fund and the diversification of the Fund's

portfolio. The SEC also alleged that Ambassador and Oglesby failed to comply with the risk-limiting provisions of Rule 2a-7 under the Investment Company Act of 1940 (the "**Investment Company Act**"), failed to conduct appropriate stress testing of the Fund's portfolio, as required by Rule 2a-7(c)(10)(v), and failed to implement written policies and procedures to provide for periodic stress testing.

According to the SEC's order charging Ambassador and Oglesby, Ambassador and Oglesby deceived the Fund's trustees by withholding information regarding the credit risk of portfolio securities. (For example, according to the SEC, Ambassador exceeded its own maturity restriction policies and did not comply with its and Rule 2a-7's requirement that, when a security is purchased by a money market fund, written records be made regarding "minimal credit risk determinations.") Furthermore, the SEC alleged that Ambassador and Oglesby misrepresented to the Fund's board the Fund's exposure to investments in European financial institutions that were potentially affected by the Eurozone crisis in 2011 and, on multiple occasions, violated Rule 2a-7(c)(4)(i)(A), which prohibits the total assets of a money market fund from being composed of more than 5% of a single issuer's securities.

In addition, as discussed in the ***March 9, 2010 Davis Polk Investment Management Regulatory Update***, on February 23, 2010, the SEC adopted amendments to Rule 2a-7 that, among other things, require money market funds to stress test their portfolios against certain market events, including changes in interest rates, shareholder redemptions and defaults, and to implement written policies and procedures to provide for such stress testing. According to the SEC, Ambassador did not implement adequate written policies and procedures until May 2012, and failed to perform stress testing for certain hypothetical scenarios, including shareholder redemptions and potential downgrades of portfolio securities.

Under Rule 2a-7, money market funds are permitted to use the amortized cost method of valuation only if the Fund is in compliance with the requirements of Rule 2a-7(c) (e.g., diversification limits and stress testing), but, according to the SEC, because Ambassador did not meet the conditions of Rule 2a-7(c), it should have valued shares according to Rule 22c-1 under the Investment Company Act (i.e., at a price based on the net asset value of such securities rather than the amortized-cost price of $1.00 per share).

Based on this conduct, the SEC charged Ambassador with violating (and Oglesby with aiding and abetting Ambassador's violations of) Sections 206(1) and (2) of the Advisers Act and Rule 22c-1 under the Investment Company Act. In addition, among other charges, Ambassador and Oglesby were charged with causing the Fund's alleged violations of Rule 38a-1 of the Investment Company Act, which requires that a registered investment company (a "**RIC**") have written policies and procedures reasonably designed to prevent federal securities law violations, Rule 34(b) of the Investment Company Act, which prohibits the making of an untrue statement of a material fact in SEC filings and Rule 35(d) under the Investment Company Act, which prohibits a RIC from having a name "that the [SEC] finds to be materially deceptive or misleading." As described in the SEC's order, Rule 2a-7(b)(2) under the Investment Company Act provides that the use of the term "money market" as part of a RIC's name is "a materially deceptive name within the meaning of Section 35(d)," unless the requirements of Rule 2a-7 are met.

For a discussion of proposed amendments to Rule 2a-7 issued by the SEC on June 5, 2013, please see the June 11, 2013 Davis Polk Client Memorandum, ***SEC Proposes Amendments to Money Market Fund Rules*****.**

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

SEC Charges Two Investment Advisers for Engaging in Undisclosed Principal Transactions and Other Violations

On November 26, 2013, the SEC issued orders instituting administrative and cease-and-desist proceedings against Parallax Investments, LLC ("**Parallax**"), a Houston-based investment adviser

formerly registered with the SEC, Tri-Star Advisors, Inc. ("**TSA**," and together with Parallax, the "**Advisers**"), also a Houston-based investment adviser registered with the SEC, and certain of their principals and employees, with engaging in thousands of principal transactions with advisory clients through an affiliated broker-dealer, without providing prior written disclosure to, or obtaining consent from, the Advisers' clients. In addition, the SEC charged Parallax with violating Section 206(4) of the Advisers Act and Rule 206(4)-2 thereunder (the "**custody rule**").

According to the SEC, from 2009 to 2011, John P. Bott ("**Bott**"), Parallax's sole owner and manager, initiated and executed more than 2,000 principal transactions without the consent of Parallax's clients. The SEC alleged that in executing such transactions, Mutual Money Investments, Inc. d/b/a Tri-Star Financial ("**TSF**"), Parallax's affiliated brokerage firm, used its inventory account to purchase mortgage-backed bonds for Parallax clients and then transferred the bonds to the relevant client accounts. The SEC also alleged that William T. Payne ("**Payne**") and Jon C. Vaughan ("**Vaughan**"), TSA's CEO and president, respectively, similarly initiated and executed more than 2,000 principal transactions through TSF (which, according to the SEC, was owned by Bott, Payne and Vaughan) without consent from TSA clients. According to the SEC, Bott, Payne and Vaughan received more than $2 million in connection with the transactions.

The SEC further alleged that, in connection with providing investment advice to Parallax Capital Partners, LP ("**PCP**"), a private fund, Parallax failed to comply with the custody rule, which, among other things, requires that an investment adviser to a private fund either undergo an annual surprise examination to verify the existence of the fund's assets or subject the fund to an annual audit by an independent public accountant registered with the Public Company Accounting Oversight Board (the "**PCAOB**") and distribute the audited financial statements to investors within 120 days after the fund's fiscal year-end. According to the SEC, in 2010, Parallax obtained an audit of PCP, but the audit was not performed by a PCAOB-registered auditor and the financial statements were not distributed to investors within the 120-day deadline. The SEC alleged that F. Robert Falkenberg ("**Falkenberg**"), Parallax's chief compliance officer during the relevant period, failed to ensure financial statements were timely distributed to investors in order to comply with the custody rule and, despite knowing (and informing Bott) that the fund's auditor was not registered with the PCAOB, Falkenberg and Bott failed to change auditors in order to comply with the custody rule.

The SEC also alleged that Parallax's 2010 financial statements included fair value disclosures that did not conform with generally accepted accounting principles because mortgage-backed securities held by PCP (which made up 94% of PCP's net asset value) were categorized as "Level One" securities (i.e., securities for which "there are quoted prices in active markets for identical assets"). According to the SEC, despite Falkenberg informing Bott that he believed a "Level Two" designation (i.e., an indication that "quoted prices in active markets do not exist for the identical asset, but the asset's fair value can be calculated directly or indirectly based on observable market inputs") was more appropriate for such securities, neither Bott nor Falkenberg discussed the fair value issues with PCP's auditor.

Based on such conduct, the SEC charged Parallax with violating (1) Section 206(3) of the Advisers Act, which prohibits an investment adviser from executing principal transactions without client consent, (2) Section 206(4) of the Advisers Act and Rule 206(4)-2 thereunder, which requires an investment adviser with custody of client assets to implement certain procedures to safeguard such assets, (3) Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder for Parallax's alleged failure to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder and (4) Section 204A of the Advisers Act and Rule 204A-1 thereunder for Parallax's alleged failure to establish, maintain and enforce a written code of ethics. The SEC alleged that Bott aided and abetted and caused Parallax's alleged federal securities law violations and that Falkenberg aided and abetted and caused Parallax's alleged custody rule and compliance violations.

In addition, the SEC charged TSA with violating (and Payne and Vaughan with causing TSA's violations of) (1) Section 206(3) of the Advisers Act and (2) Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder.

According to the orders, among the determinations to be made pursuant to the proceedings is whether any remedial action, including disgorgement and civil penalties, should be sought against the various respondents.

- **See a copy of the SEC's press release**
- **See a copy of the SEC's order against Parallax, Bott and Falkenberg**
- **See a copy of the SEC's order against TSA, Payne and Vaughan**

Notes from Europe: European Regulatory Developments

UK: Consultation on New Rules Regarding Soft Dollars Commissions

On November 25, 2013, the United Kingdom's ("**UK**") Financial Conduct Authority (the "**FCA"**) published a consultation paper on the use of dealing commission rules for investment managers (CP13/17). The consultation paper forms part of the FCA's wider asset management strategy, which is focused on ensuring that asset managers, acting as agents on behalf of their clients, put their customer's interests "at the heart of their business." In the consultation paper, the FCA has made it clear that it expects asset management firms to ensure that they seek to control costs to clients with as much rigor as they pursue investment returns. The consultation paper follows an October 30, 2013 speech by Martin Wheatley, Chief Executive of the FCA, on shaping the future of asset management, in which he called for greater transparency to boost the reputation of the asset management sector and a debate as to how and where dealing commission is spent.

The present UK regime on dealing commission dates from 2006 when the UK Financial Services Authority (the "**FSA**") introduced rules in response to the potential conflict of interest for asset managers with their brokers and clients created by "soft" or "bundled" commission arrangements. While stopping short of unbundling, the current rules (found in Chapter 11.6 of the FCA's Conduct of Business Sourcebook) prevent asset managers from acquiring any goods or services from brokers in return for client dealing commissions, except for execution-related and research goods and services. In November 2012, the FSA identified certain use of dealing commission failings in a report on conflicts of interest between asset managers and their customers.

The FCA is now proposing to make three substantive changes to these rules:

- Corporate access will be defined and added to the list of examples of goods and services that relate to the execution of trades or the provision of research that are not exempt and that cannot therefore be paid for from dealing commission; (corporate access is the practice of third parties, often investment banks, arranging for investment managers to meet with the senior management of companies in which the investment manager invests or in which the investment manager may subsequently invest, on behalf of their customers);
- Charging goods and services to dealing commissions that do not meet the criteria laid down in the rules for exemption will tend to establish non-compliance with dealing commission rules. This effectively introduces a presumption of a rule breach if the criteria are not met and addresses other practices that the FCA is concerned about (e.g., the purchase of raw data feeds, translation services and preferential access to initial public offerings) and others that might emerge in the future; and
- A reiteration of investment managers' obligation to be mindful of the duty to act in their customers' best interests. The proposed rules specifically note, by way of an example of acting in the client's

best interest, that investment managers should not pass on charges to their customers that are greater than the cost charged by the broker or relevant third party for the goods and services provided with dealing commission.

The consultation period for the proposed rules will conclude on February 25, 2014. The FCA will aim to publish a policy statement containing the final rules in spring 2014. The amendments will be made by way of the Conduct of Business Sourcebook (Use of Dealing Commission) Instrument 2013, a draft of which is set out in an Appendix to CP13/17.

- **See a copy of the FCA's November 2013 consultation paper**
- **See a copy of the Martin Wheatley's October 30, 2013 speech**
- **See a copy of the FSA's November 2012 consultation paper**

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**