Investment Management Regulatory Update

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SEC Rules and Regulations

SEC Staff Releases Additional FAQs related to Money Market Fund Reforms

On January 13, 2016, the Division of Investment Management of the Securities and Exchange Commission (the "**SEC**") issued additional responses (the "**Responses**") to frequently asked questions related to the money market reforms adopted in July 2014. For details on previously posted SEC responses to frequently asked questions regarding the 2014 money market reforms, please see the ***May 20, 2015 Investment Management Regulatory Update***. For a detailed discussion of the amendments to the rules and related requirements governing money market funds, please see the August 5, 2014 Davis Polk Client Memorandum, ***SEC Adopts Money Market Fund Reforms***. The Responses provided guidance on several money market topics, including:

Form N-CR. The Responses clarified that a stable NAV money market fund should report on Form N-CR reverse stock splits intended to increase or stabilize its NAV per share under certain circumstances. The staff noted that Part F of Form N-CR requires a stable NAV money market fund to report when its current NAV per shares deviates downward by more than one quarter of one percent from its intended stable price per share. According to the staff, a reverse stock split could obscure what could be a significant deviation beyond the reporting threshold, so the staff believes the deviation should be reported on Part D as if the reverse stock split had not occurred.

The Responses also noted that an unregistered fund that undertakes to comply with Rule 2a-7 under the Investment Company Act may file Form N-CR in paper format since EDGAR is not currently set up to allow an unregistered fund to file electronically. The staff recommended that such an unregistered fund also email a PDF copy of the Form N-CR filing to the Director of Investment Management or his designee on the date the paper filing is postmarked. An unregistered fund might undertake to comply with Rule 2a-7 to permit investment by registered investment companies in excess of the limits set forth in Section 12(d) of the Investment Company Act, in reliance on Rule 12d1-1 under the Investment Company Act.

Website Disclosure. The Responses also clarified that if a fund sponsor provides capital support to a money market fund in anticipation of liquidating the money market fund (a "top off"), the fund would not be required to post the information on its website after liquidation when it files Form N-CR. The fund should,

however, include such information on its website for any period between the top off and the fund's liquidation. The staff believes that the purposes of the website disclosure are not served when there are no longer shareholders of the fund. The staff cautioned that where a liquidated money market fund was party to a merger, asset sale or consolidation with another fund, the successor fund should consider disclosing financial support it received from the predecessor fund in its Statement of Additional Information. The Responses also note that a multi-class money market fund may disclose information required by Rule 2a-7(h)(10)(iii) relating to the fund's net asset value per share separately by class, rather than the net asset value per share for the fund as a whole.

Money Market Advertisements. The Responses further clarified that the disclosure requirements set forth in amended Rule 482(b)(4) under the Investment Company Act do not apply to advertisements that do not advertise the securities of any particular money market fund, and such advertisements would not need to include the disclosure statements required by such rule. Such an advertisement would include, for example, a brochure or website explaining the different types of money market funds without identifying particular funds.

Government Money Market Funds. The Responses also clarified that Rules 2a-7(a)(16) and 35d-1 (the "**Names Rule**") under the Investment Company Act do apply to money market funds that include "government" in their names. Rule 2a-7(a)(16) under the Investment Company Act defines a "government money market fund" to mean a money market fund investing 99.5% or more of its total assets in cash, government securities and/or repurchase agreements fully collateralized by cash or government securities. In its adopting release, the SEC advised that a fund must meet the Rule 2a-7(a)(16) definition in order to call itself a "government money market fund." The Names Rule additionally requires a fund to adopt a policy to invest, under normal circumstances, at least 80% of the value of its net assets in the particular type of investments suggested by its name. The Names Rule, according to the Staff, imposes a narrower set of investments options on a "government money market fund" than the 2a-7(a)(16) definition (which would, for example, allow for more cash). The staff suggested that "government money market funds" disclose their compliance with each of these rules to avoid misleading investors. If a fund includes a specific descriptor in its name (for example, suggesting a particular type of government securities), such fund should adopt a policy to invest at least 80% of the value of its net assets in the particular type of investments suggested by its name and also meet the 99.5% test.

- **See a copy of the Responses**

Industry Update

Delaware Chancery Court Rules on Preferential Transfer of Partnership's Facebook Shares as Violation of Partnership Agreement

On December 16, 2015, the Delaware Court of Chancery (the "**Court**") issued an opinion (the "**Opinion**") in *ESG Capital Partners II, LP v. Passport Special Opportunities Master Fund, LP, C.A. No. 11053-VCL* (Del. Ch. Dec. 16, 2015), denying a motion to dismiss the plaintiffs' complaint that a fund had made preferential transfers of fund property in violation of the fund agreement and Delaware law.

According to the Opinion, ESG Capital Partners II, LP (the "**Partnership**") was formed for the purpose of purchasing shares of Facebook, Inc. ("**Facebook**") before Facebook's initial public offering ("**IPO**"). It was anticipated that once Facebook completed its IPO, the Partnership would make distributions of either the Facebook shares or the cash value thereof and then dissolve. The Partnership was governed by a limited partnership agreement (the "**LPA**"), which provided that all distributions would be made in proportion to the limited partners' respective "percentage interests," defined as the number of Partnership equity interests ("**Units**") each limited partner held divided by the total number of outstanding Units.

According to the Opinion, the Partnership then made preferential transfers to certain limited partners (the "**Favored LPs**"), who received one Facebook share for each Unit that they held rather than in proportion to their percentage interests. Other limited partners (the "**Disfavored LPs**") either received no shares at all or less than one Facebook share for each Unit held. The Disfavored LPs sued the Favored LPs, claiming that the Favored LPs had been unjustly enriched and had breached the LPA by receiving excess Facebook shares.

The Favored LPs moved to dismiss the complaint for failing to state a claim on which relief could be granted, arguing that regardless of their percentage interests, they held an ownership interest in the Partnership's underlying Facebook shares and were thus entitled to one Facebook share for each Unit that they owned. The Court disagreed, stating in the Opinion that according to the Delaware Uniform Limited Partnership Act (the "**Delaware Act**"), a limited partner does not have an interest in specific partnership property, but rather a "partnership interest," which is a share of profits and losses of the limited partnership and the right to receive distributions of limited partnership assets. In addition, the Court noted that the LPA and the Partnership's private placement memorandum also specifically contained provisions in which the limited partners acknowledged that by investing in the Partnership they were acquiring an equity interest in the Partnership and not shares of Facebook stock.

The Court also disagreed with the Favored LPs' second argument, which was that because they had received the same number of Facebook shares as the number of Units they held, the distribution was ratable and in compliance with the distribution provisions of the LPA. According to the Opinion, the Partnership's distribution of one Facebook share per Unit to Favored LPs and fewer or no shares to Disfavored LPs conflicted directly with the percentage interest-based distribution provided for in the LPA.

The Opinion also analyzed the effect of a side letter (the "**Side Letter**") entered into between one of the Favored LPs (the "**Side Letter LP**") and the general partner of the Partnership (the "**GP**") on behalf of the Partnership. The Court cited the integration clause in the subscription agreement, which stated that the subscription agreement "constitutes the entire understanding among the parties with respect to the subject matter hereof, and supersedes any prior understanding and/or written or oral agreements among them." The Court held that because the Side Letter LP signed its subscription agreement one day after entering into the Side Letter, the Side Letter was superseded in its entirety by the subscription agreement.

According to the Opinion, even assuming that the Side Letter were still in effect, the GP would not have the requisite authority to bind the Partnership to certain preferential terms in the Side Letter. Specifically, according to the Opinion, paragraph 8 of the Side Letter ("**Paragraph 8**") provided that Facebook shares would be allocated to the Side Letter LP and the other limited partners in a 22.11%-77.99% ratio. The Court declared that the GP did not have the right to grant the Side Letter LP a specific percentage interest in the Partnership, since the LPA already had a mechanism for calculating percentage interest, on which many of the other LPA provisions were based. Paragraph 8 also provided that such distribution to the Side Letter LP represented "the indirect ownership of 100,000 Shares at $33 per share." However, the Court pointed out that the GP also did not have the right, either under the Delaware Act or the LPA, to grant an ownership interest in underlying Facebook shares to the Side Letter LP. According to the Opinion, the LPA did not authorize the GP to unilaterally waive those provisions that Paragraph 8 sought to modify, and the other limited partners were entitled to enforce the terms of the LPA as written without being bound by any side agreement that the GP had made without their consent.

As an example of preferential treatment that the GP was authorized to grant, the Court cited a provision in the Side Letter in which the GP agreed not to enforce an LPA provision prohibiting assignment against the Side Letter LP. The Court noted that this Side Letter provision would have been legally binding because the relevant LPA provision gave the GP the authority to consent to assignments. With respect to Paragraph 8, however, the LPA provided that any amendment to the LPA that "would materially and adversely change the specifically enumerated rights or duties of a party or of a class of parties" had to be approved by a majority of the adversely affected partners. According to the Court, Paragraph 8 fell under

this amendment provision because it shifted the risk of losses to other limited partners while protecting the Side Letter LP from any risk. As a result, the Court held that Paragraph 8 had no binding effect.

The Court further noted that under principles of agency law, if an agent's authority is limited and the counterparty is aware of such limitations, the agent can only bind its principal to the extent of its authority. According to the Court, since the Side Letter LP was aware of the GP's lack of authority to grant certain rights in the Side Letter (as demonstrated by the Side Letter LP's acknowledgment in both the subscription agreement and the LPA that it had read, fully understood and agreed to the LPA), the Side Letter LP could not then claim that the Side Letter was legally effective.

- **See a copy of the Opinion**

Litigation

SEC Charges Alternative Fund Manager with Various Disclosure Violations

On January 19, 2016, the SEC issued an order (the "**Order**") instituting and settling administrative and cease-and-desist proceedings against Equinox Fund Management, LLC ("**Equinox**"), a Denver-based registered investment adviser specializing in managed futures strategies, for overcharging management fees and misleading investors regarding the methodology used to value certain assets held by its managed futures fund, the Frontier Fund (the "**Fund**"), which is registered under the Securities Act of 1933, as amended (the "**Securities Act**").

According to the Order, the Fund operates as a series trust, with numerous series engaged in separate trading strategies, and from the inception of such series through March 2011, the Fund filed six registration statements, as well as 23 pre-effective and post-effective amendments to these registration statements, each of which consistently disclosed that Equinox charged management fees based upon each series' net asset value ("**NAV**"). However, according to the SEC, Equinox actually charged management fees based on the value of the notional assets it was managing for each series of the Fund, which included the invested amount plus leverage used in the underlying investments, resulting in Equinox's receiving $5,404,004 in additional management fees. According to the Order, in March 2011, after the Fund's independent auditors identified the discrepancy, Equinox revised the Fund's Form 10-K and registration statement to reflect that Equinox charged management fees on notional assets, but Equinox did not refund the additional management fees collected.

According to the SEC, Equinox also misled investors regarding its valuation methodology. According to the Order, Equinox obtained access to certain commodity trading advisors ("**CTAs**") by investing in customized options that used the CTAs' performance as the options' reference assets (the "**Options**"). According to the SEC, Equinox disclosed in its Form 10-K for December 31, 2010, and Forms 10-Q for March 31, 2011 and June 30, 2011, that the Options were "reported at fair value based upon daily valuations provided by a third party pricing service and corroborated by weekly counterparty settlement values." According to the Order, although Equinox received certain pricing information on a weekly basis from the counterparty to the Options (the "**Options Counterparty**"), Equinox also received indicative bid and ask prices and indicative valuations from the Options Counterparty that were materially different from the valuations Equinox assigned to the Options and ultimately reported by the Fund in its periodic filings. As such, the SEC determined that the Fund's Options' valuations were not corroborated by "weekly counterparty settlement values" as disclosed and thus were misleading to investors. In addition, according to the Order, Equinox again deviated from the Fund's disclosed valuation policies when writing down several of the Fund's Options. According to the Order, Equinox wrote-down the valuation of several Options in accordance with its disclosed valuation policy, but for an additional Option where the write-down would have had a material impact on that series' NAV, Equinox decided to transfer the Option to a different series in which the impact of the write-down would not have a material impact on that series'

NAV. According to the Order, Equinox transferred this Option at a price lower than required by the Fund's valuation policy and wrote-down the Option's valuation the following business day. The SEC determined that by making an exception for the transferred Option, the Option was not transferred in accordance with the Fund's valuation policies, and thus the disclosure regarding the transfer in the Fund's Form 10-Q stating that the transfer was made in accordance with such policies was misleading. Finally, according to the Order, Equinox failed to disclose a material subsequent event in the financial statements of one of the Fund's series when it liquidated an Option and failed to report the estimated financial effect of such action despite knowing the effect prior to issuing the financial statements.

According to the Order, as a result of its disclosure violations, Equinox willfully violated Section 17(a)(2) of the Securities Act, which prohibits any untrue statements of material fact or material omissions in the offer or sale of securities, as well as Section 17(a)(3), which prohibits engaging in any transaction, practice or course of business which operates as a fraud or deceit upon the purchaser in the offer or sale of securities. In addition, according to the SEC, Equinox caused the Fund to violation Section 13(a) of the Securities and Exchange Act of 1934, as amended (the "**Exchange Act**") and Rules 12b-20, 13a-1 and 13a-13 thereunder, which require an issuer registered pursuant to Section 12 of the Exchange Act to file, among other things, annual and quarterly reports that contain any such further material information as may be necessary to make the required statements, in light of the circumstances in which they are made, not misleading.

The SEC censured Equinox and ordered it to pay disgorgement of $5,404,004 to compensate the Fund's investors for the additional management fees charged, plus prejudgment interest of $596,063. In addition, Equinox was ordered to pay a $400,000 civil money penalty.

- **See a copy of the Press Release**
- **See a copy of the Order**

Hedge Fund Manager Settles Charges of Misleading Investors About Investment Strategy and Historical Performance

On January 28, 2016, the SEC issued an order against QED Benchmark Management, L.L.C. ("**QED Management**") and its founder (the "**Founder**") (the "**Order**"), instituting and settling administrative and cease-and-desist proceedings against the Founder and QED Management in connection with alleged violations of the antifraud provisions of the federal securities laws by the Founder and QED Management while acting as investment advisers to a pooled investment vehicle, QED Benchmark L.P. (the "**Fund**").

According to the Order, the Founder and QED Management founded the Fund in 2004 and stated to investors in marketing the Fund that the Fund would follow an algorithmic strategy focusing on numerous varying metrics while, in fact, the Fund invested heavily in one industry and a single stock. Further, the Fund's offering memorandum and governing document stated that a maximum of 20% of the Fund's assets could be invested in any single security. According to the Order, the Founder deviated from this stated strategy beginning in early 2009, causing the Fund to invest primarily in one industry and a single stock. The SEC stated that from 2009 to 2013, when marketing the Fund to new investors, the Founder provided these potential investors with documents that reported purported historical results for 2009 that were notably higher than the Fund's actual results.

Further, according to the Order, in 2011 the Founder invested some of his personal funds in Emo Capital Corp., Inc. ("**Emo**") through two Canadian promoters active in the penny stock market. First initiated as "part of a client acquisition strategy," according to the Order, the Founder then began investing the Fund's money in Emo through purchasing convertible debentures of Emo such that by December 2011, Emo convertible debentures represented more than 50% of the Fund's net asset value. The SEC found that, not only did the Founder not disclose this investment and the financial conflict of interest of QED Management (in expecting the Canadian promoters to find new clients) to the Fund's investors, QED Management was not authorized to make an investment that contradicted the terms of the Fund's

governing document or to waive conflicts of interest on behalf of the Fund. Also, according to the Order, the Founder provided the Fund's administrator (the "**Administrator**") valuations for the Fund's Emo holdings that were not supported by Emo's public trading price; such valuations were incorporated into the Fund's 2011 "performance" and used to solicit additional investments.

The SEC noted that when the Administrator became concerned with the valuation and liquidity of the Emo holdings, in September 2012 the Founder requested and received from an entity associated with the promoters a letter offering the Fund a put option so that the Fund could sell its entire Emo holdings at $0.72 a share when the bid-ask average at that time was $0.44; the option was open until March 2013, until which time the Fund's statements to investors reflected a $0.72 per share valuation. According to the Order, Emo common stock and the illiquid convertible debentures collectively accounted for 100% of the Fund's net asset value by February 2013 and by the end of March 2013, as the option was not exercised, the Fund's statement reflected a net asset value based on a closing price of $0.043 per share. According to the SEC, an entity associated with the promoters provided the Founder with another letter in April 2013 offering the Fund a put option to sell its entire holdings at $1.00 at any time until December 2013—an option valued at nearly $3.7 million by the Administrator. However, the SEC noted that months before the put option's expiration, the same entity wrote another letter nullifying the put option and offering instead an overvalued asset from the promoters' portfolio, namely $3.4 million in illiquid convertible debentures from Darkstar, an SEC-registered shell company. The SEC found that the Founder performed no due diligence on Darkstar before accepting the exchange. In addition, according to the SEC, in August 2013 the Founder hired a new fund administrator, and provided the new Fund administrator with valuation memoranda that valued the various convertible debentures the Fund held at their principal amounts, when the shares into which the debentures would convert were valued at much less.

Finally, the SEC noted that when several investors sought information from the Founder regarding the Fund in 2013, the Founder misrepresented that the Fund had an illiquid investment taking up about 35% of the Fund when the Fund had no liquid assets at the time. According to the Order, the Fund later sold the Emo common stock at a heavy loss and used the proceeds, along with the proceeds from a new investor introduced by the promoters, to fund partial redemption for some investors.

As a result of the conduct describe above, the SEC found that the Founder and QED Management willfully aided, abetted, and caused QED Management's violations of Sections 206(1), 206(2) and 206(4) of the Investment Advisers Act of 1940, as amended which generally prohibit fraudulent conduct by an investment adviser, and Rule 205(4)-8 promulgated thereunder, which prohibits fraudulent conduct by advisers to "pooled investment vehicles" with respect to investors or prospective investors in those pools, as well as Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, which prohibit fraudulent conduct in the offer and sale of securities and in connection with the purchase and sale of securities.

The Founder and QED Management agreed to settle the charges without admitting or denying the SEC's findings. The Founder has agreed to pay $2.877 million to the SEC to reimburse Fund investors for their losses. The SEC also imposed sanctions on the Founder and QED Management. According to the Order, the Founder agreed to pay a civil penalty of $75,000 to the SEC and to be barred from the securities industry.

- **See a copy of the Order**

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