

Investment Management Regulatory Update

April 27, 2015

SEC Rules and Regulations

- SEC Adopts Final Regulation A+ Rules
- SEC Grants No-Action Relief from Section 206(4) to 16th Amendment Advisors LLC
- SEC Grants No Action Relief from Sections 12(d)(1)(A) and (B) and 17(a) of the Investment Company Act to Franklin Templeton Investments

Industry Update

- Division of Corporation Finance Issues Policy Statement on Granting Disqualification Waivers under Regulation A and Rules 505 and 506 of Regulation D
- Acting Director of the Division of Investment Management Discusses Enhanced Data Reporting and Portfolio Composition Risks
- Acting Director of the Division of Investment Management Discusses Enhanced Data Reporting, Transition Plans and Stress Testing

Litigation

- SEC Announces Fraud Charges Against Investment Advisers Accused of Concealing Poor Performance of CLO Funds
- SEC Announces Enforcement Action Against Restrictive Language in Confidentiality Agreements

SEC Rules and Regulations

SEC Adopts Final Regulation A+ Rules

On March 25, 2015, the Securities and Exchange Commission (the “**SEC**”) adopted amendments to Regulation A of the Securities Act of 1933, as amended (the “**Securities Act**”), a Securities Act exemption for offerings by nonpublic US and Canadian companies. The final rules (colloquially called “Regulation A+”) enable companies to offer and sell up to \$50 million of securities in a rolling 12-month period in public offerings without complying with the normal registration requirements of the Securities Act. The rules, which are required by the JOBS Act of 2012, are one piece of Congress’s efforts to facilitate capital raising by smaller companies.

As adopted, Regulation A+ will offer some nonpublic companies a middle way between remaining private and going public. The final rules provide for two tiers of offerings:

- Tier 1 offerings of up to \$20 million in a rolling 12-month period, of which no more than \$6 million may be sold by affiliated shareholders.
- Tier 2 offerings of up to \$50 million in a rolling 12-month period, of which no more than \$15 million may be sold by affiliated shareholders.

A company issuing up to \$20 million of securities can elect to do so under Tier 1 or Tier 2. For a detailed discussion of the amendments to Regulation A, please see the March 30, 2015 Davis Polk Memorandum, [SEC Adopts Final Regulation A+ Rules](#).

- [See a copy of the amendments to Regulation A](#)

SEC Grants No-Action Relief from Section 206(4) to 16th Amendment Advisors LLC

On March 23, 2015, the Division of Investment Management (the “**Division**”) of the SEC issued a letter (the “**Letter**”) to 16th Amendment Advisors LLC (“**16th Amendment**”) providing no-action relief from the independent verification and account statement provisions of clauses (a)(2), (a)(3) and (a)(4) of Rule 206(4)-2 promulgated under Section 206(4) of the Investment Advisers Act of 1940, as amended (the “**Custody Rule**”) in relation to 16th Amendment’s management of Vicksburg Municipal Trading Fund LP (the “**Master Fund**”) and a private feeder fund into the Master Fund, Vicksburg Municipal Trading Offshore Fund LTD (the “**Feeder Fund**,” and together with the Master Fund, the “**Funds**”).

The Custody Rule generally requires, among other things, that a registered investment adviser with custody of client funds or securities take certain steps designed to safeguard those client assets, including by maintaining such client assets with qualified custodians. According to the Letter, the Custody Rule further requires that the adviser (i) have a reasonable basis, after due inquiry, for believing that the qualified custodian sends quarterly account statements to the client and (ii) generally undergo an annual surprise examination by an independent public accountant to verify the client funds and securities. The Custody Rule generally provides that an adviser to a pooled investment vehicle shall be deemed to have complied with the independent verification requirement and account statements delivery requirement if the adviser subjects the fund to an annual audit by an independent public accountant registered with the Public Company Accounting Oversight Board and distributes the audited financial statements to investors within 120 days after the fund’s fiscal year-end.

According to the Letter, Evan Lamp, John Lee and Richard McCarthy, together with their family members and family trusts, own a 91% interest in 16th Amendment, a registered investment adviser. In Schedule A to Form ADV, 16th Amendment represented that each of Messrs. Lamp, Lee and McCarthy is listed as a “control person” because of his status as an officer of 16th Amendment. 16th Amendment further represented that its remaining 9% interest is owned passively by Bidyut Sen, who has certain rights under Delaware law to access to information concerning 16th Amendment’s affairs. According to the Letter, 16th Amendment stated that it currently manages the Master Fund through a general partner entity (the “**General Partner**”) jointly managed by Messrs. Lamp, Lee and McCarthy, and that Messrs. Lamp, Lee and McCarthy further control the Feeder Fund by being directors of the Feeder Fund. Because of this arrangement, according to 16th Amendment, Messrs. Lamp, Lee and McCarthy have access to all information concerning the affairs of the General Partner and of the Feeder Fund.

In the Letter, the Division stated that, based on the facts and representations in 16th Amendment’s request for no-action relief, it would not seek enforcement action against 16th Amendment if it does not comply with the independent verification and account statement delivery provisions of clauses (a)(2), (a)(3) and (a)(4) of the Custody Rule in connection with the Funds. In granting such relief, the Division relied on the facts set forth above as well as on 16th Amendment’s representations that the only investors in the Funds are:

- Individuals who “(a) have plenary access to information (either statutory, contractual or some combination of the two) concerning the management of 16th Amendment, the Funds, and each of the Fund’s general partners (or equivalent), (b) are listed as “control persons” in Schedule A to Form ADV because of their status as 16th Amendment’s officers or directors with executive responsibility (or having a similar status or function) and (c) have a material ownership in 16th Amendment (the “**Principals**”);” and
- The Principals’ spouses and minor children, as well as investment vehicles established for the individual or joint benefit of the Principals, their spouses or minor children.
- ▶ [See a copy of the Letter](#)

SEC Grants No Action Relief from Sections 12(d)(1)(A) and (B) and 17(a) of the Investment Company Act to Franklin Templeton Investments

On April 3, 2015, the Division of Investment Management (the “**Division**”) of the SEC issued a letter (the “**Letter**”) to Franklin Templeton Investments (“**FTI**”) providing no-action relief from Sections 12(d)(1)(A) and (B) and 17(a) of the Investment Company Act of 1940 (the “**Investment Company Act**”). The Division stated that it would not recommend enforcement action against FTI, the investment manager under its direct or indirect control (the “**FTI Manager**”) or an open-end investment company registered under the Investment Company Act within the FTI group of investment companies that is advised by FTI Manager (each, a “**Fund**” and together, the “**Funds**”) if a Fund purchases or otherwise acquires shares of another Fund in excess of the limits in Section 12(d)(1)(A) of the Investment Company Act and the other Fund sells its shares to the acquiring Fund in excess of the limits in Section 12(d)(1)(B) of the Investment Company Act.

Section 12(d)(1)(A) of the Investment Company Act generally prohibits a registered investment company (a “**RIC**”) from acquiring securities issued by another RIC if, immediately after the acquisition, the acquiring RIC: (i) owns more than three percent of the outstanding voting stock of the acquired RIC; (ii) has more than five percent of its total assets invested in the acquired RIC; or (iii) has more than ten percent of its total assets invested in the acquired RIC and all other RICs. Section 12(d)(1)(B) of the Investment Company Act generally prohibits a RIC from knowingly selling its securities to another RIC if the sale will cause the acquiring RIC to own more than 3% of the acquired RIC’s total outstanding voting stock, or if the sale will cause more than 10% of the acquired RIC’s total outstanding voting stock to be owned by RICs. According to the Letter, these provisions were designed to prevent potential abuses—the layering of fees, the pyramiding of control and undue influence and overly complex structures—that could arise from investments by RICs in other RICs.

Section 12(d)(1)(G) of the Investment Company Act, according to the Letter, provides (among other things) a conditional exemption from the percentage limits in Sections 12(d)(1)(A) and (B) for certain fund of funds arrangements within the same group of RICs. One of the conditions in Section 12(d)(1)(G) requires an acquired RIC to have a policy that prohibits it from investing in shares of other RICs in reliance on Section 12(d)(1)(F) or (G) of the Investment Company Act.

According to the Letter, various Funds invest a portion of their assets directly in floating rate instruments. FTI intends to construct a three-tier arrangement whereby a Fund invests in an underlying Fund which in turn invests in a fund to be offered exclusively to the Funds (the “**Central Fund**”). According to FTI, the creation of this Central Fund is intended to reduce settlement costs and other inefficiencies stemming from managing each Fund’s investment in floating rate instruments separately. FTI represented that the three-tier arrangement would be on the following terms:

- The investment by a Fund in an underlying Fund would comply with the provisions of Section 12(d)(1)(G) except that the underlying Fund would have an exception to its policy not to acquire securities of a registered open-end investment company in reliance on Section 12(d)(1)(G) solely for the purpose of acquiring shares of the Central Fund.
- An underlying Fund will not exceed the 5% limit with respect to an investment in the Central Fund, or the 10% limit with respect to investments in RICs generally (including the Central Fund) and companies relying on Section 3(c)(1) or 3(c)(7) of the Investment Company Act (“**Private Funds**”).
- The FTI Manager to an underlying Fund will waive management fees otherwise payable by such underlying Fund to the FTI Manager in an amount equal to any management fees paid by the Central Fund to an FTI Manager.
- Shares of the Central Fund will not be subject to a sales load, redemption fee or a distribution fee under a plan adopted in accordance with Rule 12b-1 under the Investment Company Act.

- The Central Fund will not acquire securities of any Private Fund in excess of the Section 12(d)(1)(A) limits.
- Shares of the Central Fund will be sold only to the Funds.
- Prior to the initial investment by an underlying Fund in the Central Fund, the board of directors of each of the Funds and the underlying Fund will consider the reasons and benefits behind such investment.

In the Letter, the Division stated that, based on the facts and representations set forth in FTI's request for no-action relief, it would not recommend enforcement action to the SEC if a Fund acquires shares of an underlying Fund that, in turn, acquires shares of the Central Fund in reliance on Section 12(d)(1)(G) of the Investment Company Act.

- ▶ [See a copy of the Letter](#)

Industry Update

Division of Corporation Finance Issues Policy Statement on Granting Disqualification Waivers under Regulation A and Rules 505 and 506 of Regulation D

The Division of Corporation Finance (“**CorpFin**”) recently issued a policy statement (the “**Statement**”) regarding the granting of waivers from disqualification under Rule 262 of Regulation A (“**Rule 262**”) under the Securities Act, and Rules 505 (“**Rule 505**”) and 506 (“**Rule 506**”) of Regulation D under the Securities Act.

The disqualification provisions of Rule 262 and Rule 505 make exemptions from registration unavailable for an offering if, among other things, certain covered persons are subject to certain disqualifying events (including certain administrative orders, industry bars, an injunction involving select securities law violations or specified criminal convictions). The disqualification provisions of Rule 506 are similar to those of Rule 262 and Rule 505, but have slightly different covered parties. For instance, Rule 506(d) includes as covered persons beneficial owners of 20 percent (rather than 10 percent, as is the case under Rule 262 and Rule 505) or more of an issuer's voting equity securities. In addition, Rule 506(d) includes any investment manager, and any of its directors or officers participating in the offering, of an issuer that is a pooled investment fund, while such persons are not included as covered persons under Rule 262 and Rule 505. Furthermore, the disqualifying events in Rule 506(d) are broader than those under Rule 262 and Rule 505, including, among other differences, final orders of certain state and federal regulatory authorities.

According to the Statement, the SEC has delegated authority to grant waivers to disqualification from the Safe Harbors to the Director of CorpFin, but retains the authority to consider waiver requests and review actions taken pursuant to the delegated authority. CorpFin stated that it will consider, among other things, the factors set forth below when it evaluates whether a party seeking a waiver has shown good cause that the exemption should not be denied under the circumstances:

- **The nature of the violation or conviction and whether it involved the offer or sale of securities:** CorpFin would analyze in particular whether the conduct involved a criminal conviction or scienter-based violation (in which case the burden on the applicant is “significantly greater”).
- **The level of responsibility of the waiver applicant in the misconduct and the role that the bad actor plays with respect to the waiver applicant:** In particular, CorpFin stated that it would look negatively on circumstances where the bad actor was the party applying for the waiver and still exerted influence on the business of the entity seeking the waiver.

- **Whether the misconduct reflects more broadly on the entity as a whole:** According to CorpFin, it would look positively on actions taken by the waiver applicant to remove or terminate the association with individual(s) who committed the misconduct leading to disqualification.
- **The duration of the misconduct:** According to the Statement, misconduct that occurred over an extended period of time, as opposed to an isolated incident of misconduct, would weigh unfavorably in the waiver consideration.
- **The extent to which remedial measures have been taken:** CorpFin stated that it would consider when the remedial measures began and how likely they were to prevent the recurrence of the misconduct and mitigate the possibility of future violations. In particular, CorpFin would look at whether there have been (i) changes in control of the party seeking the waiver and (ii) steps taken to improve the waiver applicant's training, policies, procedures or practices. According to the Statement, CorpFin would focus on how the remedial steps undertaken by the waiver applicant would improve the waiver applicant's ability to prevent future misconduct and the resulting harm to investors, clients or customers.
- **What impact a denial of the waiver would have on third parties:** According to the Statement, CorpFin would review the impact that failing to grant a waiver would have on investors, clients and/or customers of the applicant. In light of this, CorpFin advised waiver applicants to submit information concerning whether or how often they have used the relevant exemption in the past, or how they plan to use the exemption in the future, and explain in its application why a waiver is needed.

In the Statement, CorpFin noted that no single factor is dispositive and that the burden will be on the waiver applicant to show good cause that it is not necessary under the circumstances for an exemption to be denied. CorpFin went on to say that the focus of its analysis will be on how the identified misconduct bears on the applicant's fitness to participate in exempt offerings under the applicable regulations.

- ▶ [See a copy of the Statement](#)

Acting Director of the Division of Investment Management Discusses Enhanced Data Reporting and Portfolio Composition Risks

On March 5, 2015, David Grim, the Acting Director of the Division of the Investment Management (the "**Division**") of the SEC addressed the PLI Investment Management Institute 2015 to discuss enhanced reporting, data collection and the portfolio composition risks associated with derivatives and liquidity. Grim explained that, in order to improve the SEC's regulatory overview of the asset management industry, the Division has been developing recommendations in order to: (i) modernize and enhance data reporting; (ii) require registered funds to implement controls to better identify and manage the risks related to the diverse composition of their portfolios; and (iii) better plan for the effect that market stress events, or the inability of an adviser to serve its clients, has on investors.

Grim first spoke about several ways data reporting has been modernized and enhanced to keep up with changes in the industry and technology, including the introduction of Form N-SAR in 1985, the 2003 amendments to Forms N-CSR and N-Q regarding portfolio holdings disclosure and the monthly reporting of money market funds on Form N-MFP. Grim noted that the Division was considering ways to expand on the basic information reported on Form N-SAR to reflect new market developments, products, practices and risks (including the significant growth of exchange-traded funds ("**ETFs**")). The Division is further considering, according to Grim, how to improve information reported on Forms N-CSR and N-Q to increase transparency and assist the SEC staff in assessing whether a fund's disclosure is adequate, among other things.

Grim then discussed the Division's second rulemaking initiative: the use of derivatives by investment companies and the associated portfolio composition risks. Section 18 of the Investment Company Act

places limitations on registered investment companies' ("**RICs**") issuance of "senior securities," and, according to Grim, these limitations must be considered by RICs that invest in derivatives. Grim noted that, in August 2011, the Division issued a Concept Release on the Use of Derivatives by Registered Investment Companies (the "**Concept Release**"), which summarized SEC staff guidance on both Section 18 of the Investment Company Act and Release 10666 with respect to derivatives-related issues. Grim asserted that the SEC is currently considering various comments it received in connection with two questions posed in the Concept Release: (i) whether the current approach of segregating assets adequately addresses the investor protection purposes and concerns underlying Section 18; and (ii) what the appropriate limitation on the use of leverage by RICs is to balance the goals of protecting investors and facilitating appropriate innovation in the fund industry. According to Grim, the Division is further considering whether RICs should be required to establish broad risk management programs to address risks related to their derivatives risk. For further discussion of this Concept Release, please see the September 2, 2011 Davis Polk Client Newsflash, [SEC Seeks Public Comment on Mutual Fund Derivatives Use and Asset-Backed Issuers and Mortgage Related Pools under the Investment Company Act](#).

Finally, Grim addressed risks relating to liquidity and mutual funds. Mutual funds should, according to Grim, maintain a high degree of liquidity to enable them to sell the funds' assets in order to timely satisfy redemption requests. Grim stated that the Division is considering advising on a new all-inclusive approach to managing the liquidity risks in the makeup of a mutual fund's portfolio, focusing on the redemption rights of investors, updating liquidity standards and ensuring better disclosure of liquidity risks.

- ▶ [See a copy of the Speech](#)

Acting Director of the Division of Investment Management Discusses Enhanced Data Reporting, Transition Plans and Stress Testing

On March 6, 2015, David Grim, the Acting Director of the Division of the Investment Management (the "**Division**") of the SEC addressed the IAA Compliance Conference to discuss enhanced data reporting, transition plans and stress testing.

Grim first spoke about several ways data reporting has been modernized and enhanced to keep up with changes in the industry and technology. According to Grim, the SEC has been considering ways to increase the usefulness of Form ADV for potential and current advisory clients, improve the effectiveness by which advisers report information to the SEC and improve the SEC's registration and regulatory and examination program. In addition, the SEC is considering whether to request additional information on Form ADV or Form PF. For instance, Grim noted that more information about separately managed accounts may be helpful.

Grim then discussed the SEC's ongoing discussions regarding transition plans for investment advisers to prepare for significant disruptions in their business. According to Grim, the SEC would like this new requirement to dovetail with existing compliance programs. For instance, the SEC would expect that an adviser's policies (required under Rule 206(4)-7 under the Investment Advisers Act of 1940, as amended (the "**Advisers Act**")) would also include a section on business continuity plans. Moreover, Grim noted that the SEC is cognizant that investment advisers have special characteristics that make wind downs different than those associated with other types of financial firms.

Finally, Grim addressed stress testing. Section 165(i)(2) of the Dodd-Frank Act, according to Grim, requires annual stress testing by large funds and large investment advisers, and the SEC is continuing to consider how to tailor the stress testing rules for asset management and different types of firms.

- ▶ [See a copy of the Speech](#)

Litigation

SEC Announces Fraud Charges Against Investment Advisers Accused of Concealing Poor Performance of CLO Funds

On March 30, 2015, the SEC issued an Order (the “**Order**”) instituting administrative and cease-and-desist proceedings against Lynn Tilton (“**Tilton**”) and four of her Patriarch Partners firms, including Patriarch Partners VIII, LLC (a relying investment adviser); Patriarch Partners XIV, LLC (a relying investment adviser); and Patriarch Partners XV, LLC (a registered investment adviser) (together, “**Patriarch**”), for violations of Sections 206(1), 206(2) and 206(4) of the Advisers Act and Rule 206-4(8) thereunder for breach of fiduciary duties and fraud by allegedly failing to value the assets of three collateralized loan obligation funds managed by Patriarch (the “**CLO Funds**”) pursuant to the objective methodology described in the CLO Funds’ offering documents. In addition, Patriarch Partners, LLC, whose employees (including Tilton) run the businesses of the Patriarch firms, was charged with willfully aiding and abetting and causing the above violations by Tilton and Patriarch.

According to the Order, the CLO Funds raise capital by issuing secured notes and using proceeds of those notes to purchase a portfolio consisting primarily of loans to distressed companies. Patriarch signed a collateral management agreement between each of the CLO Funds and the applicable Patriarch entity that entitled such Patriarch entity to two different fees of 1% of the assets in the deal, each payable quarterly. According to the Order, the contractual terms of the CLO Funds’ documents required Tilton and Patriarch to value the CLO Funds’ assets pursuant to a specified methodology of categorizing the value of each asset based on, among other factors, whether the loans were current in interest payments to the CLO Funds. According to the SEC, the categorization of each asset affected the “overcollateralization” ratio of each of the CLO Funds. The SEC alleged that, pursuant to the indenture of each CLO Fund, a low overcollateralization ratio would generally mean that Tilton and Patriarch would not be entitled to certain management fees, and investors would be able to exercise more control over the CLO Funds’ management (including the right to remove the applicable Patriarch entity as the CLO Funds’ collateral manager).

Rather than adhering to the categorization methodology set forth in the indentures for the CLO Funds, the SEC alleged that Tilton and Patriarch subjectively assessed the CLO Funds’ assets and failed to recategorize such assets into lower categories even when the underlying borrower had not made interest payments on the loans for several years. Furthermore, according to the SEC, Tilton and Patriarch failed to inform investors about Tilton’s discretionary approach to the loan categorization (and the failure to consider past due interest when conducting categorization analyses) or about the decline in value of the CLO Funds’ assets. The SEC alleged that Tilton and Patriarch’s discretionary approach rendered statements about asset categorization false and misleading and therefore represented a fraudulent and deceptive scheme, practice and course of business. Furthermore, according to the SEC, this approach created a significant conflicts of interest, since it allowed Tilton and Patriarch to maintain control over the poor-performing CLO Funds and retain almost \$200 million in fees and other payments. As a result, the SEC further alleged that these actions constituted a breach of Tilton and Patriarch’s fiduciary duties and contractual standard of conduct.

According to the Order, Tilton and Patriarch also included misstatements in the CLO Funds’ quarterly financials by stating that they had conducted a required impairment analysis on the assets of the CLO Funds even though they had not done so. Further, according to the Order, Tilton and Patriarch falsely stated that the CLO Funds’ assets were reported at fair value, and Tilton falsely certified that the CLO Funds’ financial statements had been prepared in accordance with Generally Accepted Accounting Principles.

The SEC ordered a public hearing before an administrative law judge for proceedings to adjudicate the allegations included in the Order and to determine remedial actions, if any.

- ▶ [See a copy of the Press Release](#)
- ▶ [See a copy of the Order](#)

SEC Announces Enforcement Action Against Restrictive Language in Confidentiality Agreements

On April 1, 2015, the SEC, which has recently been investigating workplace agreements out of concern that they may impede whistleblowing activity protected by the Dodd-Frank Act, announced its first enforcement action against a company related to the use of restrictive language in confidentiality agreements. Companies should be mindful of this type of enforcement action and take the necessary steps to review and revise their own various agreements addressing confidentiality.

The SEC, in a cease-and-desist order accompanied by a press release, charged KBR Inc. with violating Rule 21F-17, which prohibits companies from taking any action to impede whistleblowers from reporting possible securities violations to the SEC. As part of certain of its internal investigations, including those related to securities law violations, KBR asked witnesses to sign a form confidentiality agreement prior to being interviewed, warning that they could face employee discipline and/or employee termination if they discussed the particulars of the interview with others without the prior approval of KBR's legal department. While the SEC noted that it was not aware of any instance of a KBR employee being prevented from communicating with the SEC about potential securities law violations or of KBR attempting to enforce the provision, it nonetheless was concerned about a potential chilling effect. For further discussion of this enforcement action, please see the April 2, 2015 Davis Polk Client Memorandum, [SEC Announces Enforcement Action Against Restrictive Language in Confidentiality Agreements](#).

- ▶ [See a copy of the Press Release](#)
- ▶ [See a copy of the Order](#)

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
Beth M. Bates	212 450 4062	beth.bates@davispolk.com

© 2015 Davis Polk & Wardwell LLP | 450 Lexington Avenue | New York, NY 10017

This communication, which we believe may be of interest to our clients and friends of the firm, is for general information only. It is not a full analysis of the matters presented and should not be relied upon as legal advice. Please refer to the firm's [privacy policy](#) for further details.