Investment Management Regulatory Update

Litigation

Supreme Court Ruling in Mutual Fund Excessive Fee Case Generally Endorses *Gartenberg* Standard

On March 30, 2010, the United States Supreme Court released the much anticipated decision in *Jones v. Harris Associates L.P.*, 559 US ___ (2010). As reported in the ***April 7, 2009 Investment Management Regulatory Update***, the Supreme Court granted certiorari to review the case on March 9, 2009. In its decision, the Supreme Court unanimously held that a mutual fund investment adviser is not liable in a shareholder suit brought under Section 36(b) of the Investment Company Act of 1940 (the "**Investment Company Act**") unless it charges an advisory fee that is "so disproportionately large, it bears no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining."

In *Jones v. Harris Associates*, shareholders of certain Oakmark mutual funds alleged that the funds' investment adviser had charged them excessive fees in violation of Section 36(b). The District Court rejected the claims after application of the standard first articulated in *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923 (2d Cir. 1982), which requires an investor to demonstrate that the advisory fees were so excessive they could not have been properly negotiated with the fund's board of directors. The Seventh Circuit affirmed the District Court's decision but rejected the *Gartenberg* standard in favor of a market-based approach in which the board of directors is free to determine the value of advisory services in the current market, so long as the investment adviser provides full and complete disclosure to the board during fee negotiations. See the ***June 5, 2008 Investment Management Regulatory Update*** for additional coverage of the Seventh Circuit's opinion.

In its decision, the Supreme Court rejected the Seventh Circuit's market-based approach and generally endorsed the *Gartenberg* standard, finding it to be consistent with the language of the Investment Company Act and the current statutory scheme. However, the Court's holding expanded upon *Gartenberg* in at least three important areas. First, the Court stated that deference should be given to the board's judgment regarding the appropriate compensation for the fund's advisers. Whether the board is entitled to that deference, however, requires an evaluation of both the procedure and substance behind the board's decision. In order to be entitled to the deference from the reviewing court, the board must engage in a "robust" process that is "fully informed" and conducted with "care and consciousness." However, the Court carved out an exception to the deference owed to the board; in instances where the board's process is deficient or the adviser withheld important information, the reviewing court "must take a more rigorous look at the outcome." Second, the Court clarified that reviewing courts may compare the fees that an adviser charges its institutional clients with the fees it charges its mutual fund clients, while recognizing that there may be a number of legitimate reasons for a difference between the fee structures for the two different investing groups. Third, the Court held that comparisons with fees charged to different mutual funds by other advisers are problematic because those fees, like the ones being challenged, may not be the product of arm's-length negotiations.

Jones v. Harris Associates will impact the process and procedures used by mutual fund boards of directors in setting fees. First, the enhanced *Gartenberg* framework adopted by the Court means fund advisers and boards must demonstrate that fee arrangements were negotiated after receiving the necessary information and with the necessary degree of care. Thus, boards will be well advised to engage in a robust and transparent process when negotiating fee arrangements. Second, the Court's holding that reviewing courts may consider the discrepancy between fees charged to retail and institutional investors should lead fund boards to evaluate the gap between these fees and determine if they are appropriate. This, in turn, may require fund advisers to inform boards of the fees they charge other clients as well as explain, and possibly justify, the difference in those fees.

- See a copy of the Supreme Court's opinion

Federal District Court Denies SLUSA Preemption for State Law Claims Involving Hedge Fund Shares

In a recent decision, the U.S. District Court for the Southern District of New York rejected an argument that Securities Litigation Uniform Standards Act of 1998 ("**SLUSA**") preemption should apply to transactions in hedge fund shares, which are not deemed covered securities under SLUSA, where a hedge fund holds instruments that are covered securities under SLUSA. *Pension Comm. of the Univ. of Montreal Pension Plan v. Banc of Am. Sec. LLC*, No. 05 Civ. 9016 (SAS), (S.D.N.Y. February 16, 2010). SLUSA preempts state-law actions based on allegations of an untrue statement or omission of a material fact in connection with the purchase or sale of a covered security. SLUSA defines the term "covered security" as "one traded nationally and listed on a regulated national exchange or issued by an investment company that is registered, or files registration statements, under the Investment Company Act of 1940." *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71, 83 (2006) (citing 15 U.S.C. § 77p(f)(3)).

The case involved plaintiffs that were investors in two hedge funds (the "**Funds**") managed by Lancer Management Group LLC. The Funds began to lose money in March 2000 and were subsequently placed into receivership and liquidated. The plaintiffs alleged that the Funds' losses were hidden from them, and they brought claims under both federal and state law against the Funds' former directors, administrator, auditor, prime broker and custodian for making untrue statements of material fact about the Funds' NAV and performance.

The Funds' administrator, Citco Fund Services (Curacao) N.V. and two of the Funds' former directors, who were also Citco officers (collectively, the "**Citco Defendants**"), conceded that the Funds' shares

were not covered securities but brought a motion for partial summary judgment that contended that SLUSA nevertheless preempted the plaintiffs' state law claims because the Funds' portfolios consisted of covered securities.

The court found this argument unavailing, reasoning that because the Citco Defendants' alleged misstatements concerned the Funds—and not the investments held by the Funds—the statements were not made in connection with the sale or purchase of covered securities. Therefore, SLUSA preemption did not apply. "To hold otherwise," added the court, "would extend the reach of SLUSA to any investment vehicle with covered securities in its portfolio."

- See a copy of the decision

Industry Update

Senate Banking Committee Approves Sen. Dodd's Restoring American Financial Stability Act

On March 15, 2010, Senator Christopher J. Dodd (D-CT), Chairman of the Senate Committee on Banking, Housing, and Urban Affairs (the "**Senate Banking Committee**"), introduced a revised Restoring American Financial Stability Act (the "**March Dodd Proposal**"). The March Dodd Proposal, which was adopted by the Senate Banking Committee on March 22, 2010 along party lines, replaced an earlier discussion draft that was introduced on November 10, 2009 (the "**November Dodd Proposal**"). The Senate's legislative efforts follow those in the House of Representatives, which on December 11, 2009 passed the Wall Street Reform and Consumer Protection Act of 2009 (the "**House Bill**"). The November Dodd Proposal was described in the ***December 4, 2009 Investment Management Regulatory Update*** and the House Bill was reported in the ***January 7, 2010 Investment Management Regulatory Update***. For a summary of the full March Dodd Proposal, as passed, please see the Davis Polk Client Memorandums ***Summary of the March 15, 2010 Draft of the Restoring American Financial Stability Act*** and ***Summary of Manager's Amendment to the March Dodd Bill***.

The following update briefly summarizes certain portions of the March Dodd Proposal with comparisons to the November Dodd Proposal and the House Bill.

Regulation of Advisers to Hedge Funds and Others

- *Overview*. Title IV of the March Dodd Proposal ("**Title IV**"), "Regulation of Advisers to Hedge Funds and Others," generally remains the same in substance as the corresponding title of the November Dodd Proposal.
- *Elimination of "private investment adviser" exemption.* Title IV of the March Dodd Proposal, like the comparable provisions of the November Dodd Proposal and the House Bill, requires many investment advisers to private funds to register with the SEC by, among other things, eliminating the "private investment adviser" exemption contained in Section 203(b)(3) of the Investment Advisers Act of 1940 (the "**Advisers Act**"). Currently, this exemption from registration is available to investment advisers who, among other things, have had fewer than 15 clients over the preceding 12 months and who do not hold themselves out generally to the public as investment advisers.
- *Definition of "private funds."* Title IV defines the term "private fund" to be any fund that would be an investment company but for the exemptions contained in Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 (the "**Investment Company Act**"). This definition, which is identical to that adopted in the House Bill, no longer reflects an additional requirement, included in the November Dodd Proposal, that such a fund either be created in the U.S. or have 10% or more of its securities owned by U.S. persons.

- *Significant registration exemptions*. Title IV retains registration exemptions for advisers to venture capital funds and private equity funds. The continued inclusion of the private equity fund adviser exemption maintains one of the key differences between the March Dodd Proposal and the House Bill, which does not provide an exemption for advisers to private equity funds.
- *Family offices*. Family offices continue to be exempt under Title IV from the definition of the term "investment adviser," placing such entities outside the purview of the Advisers Act. Unlike the November Dodd Proposal, which also included this exemption, Title IV now requires that the SEC define "family offices," for purposes of the exemption, in a manner consistent with the SEC's prior exemptive orders.
- *Definition of "client."* Title IV now contains, consistent with current law, a prohibition against the SEC defining the term "client" for purposes of Sections 206(1) and 206(2) of the Advisers Act to include investors in a private fund. In contrast, the November Dodd Proposal authorized the SEC to ascribe different meanings to terms, including the term "client," used in different sections of the Advisers Act. The House Bill, while permitting the SEC to ascribe different meanings to terms used in different sections of the Advisers Act, clarifies that with respect to the term "client," the SEC may not ascribe a meaning that would include an investor in a private fund managed by an investment adviser, where such private fund has entered into an advisory contract with such adviser.
- *Recordkeeping and reporting*. Title IV includes recordkeeping and reporting provisions that remain broadly similar to both the November Dodd Proposal and the House Bill. All would impose extensive recordkeeping and reporting obligations on registered investment advisers with respect to any private funds that they manage.
- *Proprietary information*. Unlike the November Dodd Proposal, Title IV provides enhanced protections to proprietary information provided to the government. For example, proprietary information is excised from FOIA's coverage. Title IV's definition of the term "proprietary information" is identical to that found in the House Bill; both cover, among other things, non-public information about an adviser's trading strategies, computer hardware or software containing intellectual property, and trading data.
- *Custody of client assets*. Title IV allows the SEC to promulgate rules to require registered investment advisers to take steps to safeguard client assets over which the adviser has custody. This deviates from the November Dodd Proposal, which instructed the SEC to require investment advisers to use an independent custodian to hold client assets, "where necessary and appropriate in the public interest and for the protection of investors." This also differs from the House Bill, under which the SEC would generally be required to adopt a rule requiring investment advisers to use a qualified custodian to custody any client accounts with more than $10 million worth of client funds or securities.

The Volcker Rule

Title VI of the March Dodd Proposal incorporates, in a section entitled "Restrictions on Capital Market Activity by Banks and Bank Holding Companies," the controversial Volcker Rule (the "**Volcker Rule**"), which appeared neither in the House Bill nor in the November Dodd Proposal. The Volcker Rule, which is named after its initial advocate, former Federal Reserve Chairman Paul Volcker, was formally endorsed by President Barack Obama earlier this year, as reported in the January 25, 2010 Davis Polk Client Memorandum ***President Obama Proposes Size and Activities Limits for Financial Institutions***. Subsequently, the U.S. Department of the Treasury released proposed legislative text, described in the ***March 9, 2010 Investment Management Regulatory Update***, to serve as a framework for implementing the Volcker Rule. Broadly speaking, the Volcker Rule seeks to limit certain financial institutions from engaging in proprietary trading and sponsoring or investing in private equity funds or hedge funds.

This overview focuses on the aspects of the Volcker Rule that affect sponsoring or investing in such private funds. For a summary of the Volcker Rule's limits on proprietary trading, see the Davis Polk Client Memorandums ***Summary of the March 15, 2010 Draft of the Restoring American Financial Stability Act*** and ***Summary of Manager's Amendment to the March Dodd Bill***.

- *Generally*. The Volcker Rule, as it appears in the March Dodd Proposal, would amend the Bank Holding Company Act of 1956 ("**BHCA**") to, among other things, require "appropriate Federal banking agencies" to prohibit certain institutions from sponsoring or investing in private equity funds or hedge funds.
- *Definition of private equity funds and hedge funds*. Private equity funds and hedge funds are defined as entities that are exempt from registration as an investment company pursuant to Section 3(c)(1) or 3(c)(7) of the Investment Company Act or "a similar fund, as jointly determined by the appropriate Federal banking agencies."
- *Covered Entities*. The Volcker Rule's prohibition with respect to sponsoring or investing in a private equity fund or hedge fund would apply to insured depository institutions, any company that controls an insured depository institution, any company that is "treated as a bank holding company" for purposes of the BHCA, or any subsidiary of such an institution or company (together, "**Covered Entities**").
- *"Sponsoring" a fund.* Covered entities would be prohibited from, among other things, serving as a general partner, managing member, or trustee of a fund; selecting or controlling a majority of the directors, trustees or management of a fund; or sharing any variation of the same name with a fund for various purposes.
- *Foreign exemption*. Certain foreign companies are exempted from the Volcker Rule's ban on investing in or sponsoring private equity funds or hedge funds. To qualify for the exemption, the foreign company must, among other things, not be controlled by a U.S. domestic parent.
- *Other exemptions*. The Volcker Rule provides two narrow exceptions to the prohibition on investments in hedge funds and private equity funds. Investments in small business investment companies and certain "public welfare" investments are not prohibited.
- *Systemically important nonbank financial companies.* Under the Volcker Rule, any systemically important "nonbank financial company" that sponsored or invested in hedge funds or private equity funds (other than pursuant to certain narrow exceptions) would be subject to additional capital requirements and additional quantitative limits to be adopted by the Board of Governors of the Federal Reserve System.
- *Limitations on transactions and relationships.* The Volcker Rule would introduce limitations on certain transactions or relationships with hedge funds and private equity funds. For example, a Covered Entity that acts as an investment adviser or investment manager to a hedge fund or private equity fund would be (i) barred from entering into any covered transaction, as defined in Section 23A of the Federal Reserve Act, with the fund that it advised or managed (such as making a loan to the fund or guaranteeing the fund's obligations) and (ii) subject to Section 23B of the Federal Reserve Act as if such Covered Entity were a member bank and such fund were an affiliate (which would essentially require transactions between them to be on arm's-length terms).

Broker-Dealer Regulation

Subtitle A of Title IX of the March Dodd Proposal (the "**Investor Protection Title**"), "Increasing Investor Protection," would introduce certain changes with respect to the regulation of broker-dealers and investment advisers.

Certain significant provisions of the Investor Protection Title are discussed below.

- *Fiduciary duty study*. The Investor Protection Title requires that the SEC study the effectiveness of existing standards of care for broker-dealers and investment advisers for providing personalized investment advice and recommendations about securities to retail customers. If the study concludes that gaps or overlaps exist, the SEC is required to promulgate rules within two years of the enactment of the March Dodd Proposal. Notably, this provision is a sharp break with both the November Dodd Proposal and the House Bill. The November Dodd Proposal would have required most broker-dealers to register as investment advisers, and the House Bill requires the SEC to impose a fiduciary duty on broker-dealers providing investment advice about securities to retail customers.
- *Applicability of Section 205*. The Investor Protection Title clarifies that the restrictions on investment advisory contracts contained in Section 205 of the Advisers Act does not apply to any investment adviser not registered or required to be registered with the SEC.
- *No aiding and abetting authority*. The November Dodd Proposal included provisions, which are not included in the March Dodd Proposal, to expand the SEC's authority to pursue aiders and abettors of securities laws violators, or to extend this authority under the Securities Act of 1933, the Investment Company Act and the Advisers Act.
- *Restriction of mandatory pre-dispute arbitration*. The Investor Protection Title authorizes the SEC to conduct rulemaking to reaffirm or prohibit the use of mandatory arbitration pre-dispute agreements for customers or clients of broker-dealers and investment advisers.

We will continue to monitor legislative developments in this area.

- ► See a copy of the March Dodd Proposal
- ► See a copy of Senator Dodd's Manager's Amendment

SEC to Review Derivative Use by Mutual Funds, ETFs and Other Investment Companies; Defers Consideration of Certain ETF Exemptive Orders

On March, 25, 2010, the SEC issued a press release announcing that it is conducting a comprehensive review of the use of derivatives by mutual funds, exchange-traded funds ("**ETFs**") and other investment companies. Until the completion of its review, the SEC has decided to defer its consideration of exemptive requests under the Investment Company Act of 1940 (the "**Investment Company Act**") that seek "to permit ETFs that would make significant investments in derivatives." Existing ETFs and "other types of fund applications" are not affected by this deferral, according to the SEC.

Issues that the SEC intends to address in its review include, but are not limited to, the following:

- whether market practices involving derivatives can be squared with the Investment Company Act's leverage, concentration and diversification provisions;
- whether funds that make considerable use of derivatives, especially funds that utilize derivatives "to provide leveraged returns," have in place adequate risk management and other related procedures;
- whether fund directors provide adequate oversight of funds' use of derivatives;
- whether issues posed by the use of derivatives with respect to fund pricing and liquidity determinations are sufficiently addressed by existing rules;
- whether existing prospectus disclosures effectively communicate the risks posed by the use of derivatives; and

- whether special reporting requirements should be instituted with respect to funds' "derivatives activities."

Commenting on the SEC's decision to undertake this study, Andrew J. Donohue, Director of the SEC's Division of Investment Management, acknowledged that "the use of derivatives by funds is not a new phenomenon." Nevertheless, according to Donohue, the SEC "want[s] to be sure [that its] regulatory protections keep up with the increasing complexity of these instruments and how they are used by fund managers."

In March 2008, the SEC proposed Rule 6c-11 under the Investment Company Act (the "**ETF rule**") which, if adopted, would permit ETFs to operate without obtaining exemptive orders from the SEC. See the ***April 14, 2008 Investment Management Regulatory Update*** for more information on the ETF rule. Recent comments by Mr. Donohue have suggested that the SEC might seek to adopt the ETF rule in the coming months. As proposed, the ETF rule does not distinguish between ETFs that use derivatives as a significant part of their investment strategy and those that do not. No indication has yet been given as to whether the decision to postpone approvals for derivative-oriented ETFs will affect the prospects or timing of the ETF rule.

- See the SEC's press release

Developments Regarding the Directive on Alternative Investment Fund Managers

The European Commission's Directive on Alternative Investment Fund Managers (the "**Directive**") continues to be the focus of much controversy and debate. See the ***May 8, 2009*** and ***February 5, 2010 Investment Management Regulatory Updates*** for additional coverage of the Directive. Much, though by no means all, of the controversy stems from the Directive's potential to curtail, or otherwise significantly limit, the ability of non-European Union ("**EU**") funds to be marketed in the EU.

Most recently, Treasury Secretary Timothy Geithner and the Institutional Limited Partners Association ("**ILPA**"), an industry organization that represents large institutional investors in private equity, separately sent letters to the European Commissioner for Internal Market and Services, Michel Barnier (the "**Commissioner**"), indicating their respective concerns with the Directive. Additionally, Senator Charles Schumer (D-NY) sent a letter to Treasury Secretary Geithner criticizing the Directive and threatening to pursue equally protectionist legislation should the Directive be adopted. Lastly, on account of the lack of consensus surrounding the Directive, planned discussions regarding it were removed from the agenda of the March meeting of the European Finance Ministers.

- *Geithner's letter.* Treasury Secretary Geithner's letter to the Commissioner, dated March 1, 2010, emphasized the need for cooperation between the United States and the EU with respect to financial regulation and recalled their G-20 commitment "to avoid discrimination and maintain a level playing field." Treasury Secretary Geithner expressed concern about the potentially discriminatory impact the Directive would have on the ability of U.S. firms to access the EU market and concluded by urging the Commissioner to "ensure that non-EU fund managers and global custodian banks have the same access as their EU counterparts."
- *ILPA's letter*. In a detailed letter to the Commissioner, dated March 8, 2010, ILPA outlined a number of negative potential implications of the Directive on private equity "as an institutional investment asset class." At its core, the ILPA letter indicated that the effect of the Directive would be to place material restrictions on the ability of EU investors to invest in non-EU private equity funds. This would be problematic, according to ILPA, because "it likely would lower returns to EU investors and elevate their overall risk profile." ILPA also criticized the limits on the use of leverage contained in the Directive, stating that a "one size fits all" approach to regulating leverage and leverage ratios counterintuitively introduces an additional element of risk to investing in private equity. ILPA also expressed concern about the potential for the increased

compliance costs that would be associated with the Directive being passed on to investors, which would have the effect of diminishing their net returns. Moreover, ILPA emphasized that the Directive's mandatory disclosure requirements pertaining to potentially sensitive information of private equity portfolio companies may affect the competitiveness of these companies and, thereby, returns to investors in private equity funds.

- *Schumer's letter and proposed legislation*. Recently, Senator Schumer sent a letter to Treasury Secretary Geithner that described the Directive as a set of "protectionist rules that discriminate against U.S. firms and activities." He urged Treasury Secretary Geithner to cooperate with the Commissioner, the European Council and the European Parliament in order to ensure the adoption of more balanced provisions. Senator Schumer indicated that, should the EU adopt a protectionist version of the Directive, he intends to "call on Congress to pass equivalent legislation" that would prohibit non-U.S. funds from marketing or raising money in the United States and would require all funds operating in the United States to use U.S. banks for custody purposes.
- *Negotiations postponed*. Recent news reports revealed that the Directive was to be discussed at the EU Finance Ministers meeting held on March 16, 2010, but was removed from the agenda—purportedly at the urging of Gordon Brown, the Prime Minister of the United Kingdom—to allow for more time to reach consensus on the provisions of the Directive.

We will continue to monitor developments in this area.

- See a copy of Geithner's letter to the Commissioner
- See a copy of ILPA's letter to the Commissioner
- See a copy of Schumer's letter to Geithner

New Developments Regarding Pay-to-Play Practices

As previously reported in several *Investment Management Regulatory Updates*, including, among others, the ***November 11, 2009***, ***January 7, 2010*** and ***March 9, 2010 Investment Management Regulatory Updates***, pay-to-play practices have been, and continue to be, the subject of much scrutiny. Recently, in connection with a two-year, ongoing investigation of pay-to-play practices involving the Office of the New York State Comptroller (the "**OSC**") and the New York State Common Retirement Fund (the "**NYCRF**"), New York State Attorney General Andrew M. Cuomo announced the guilty plea of David Loglisci, the former Chief Investment Officer ("**CIO**") at the OSC. Further, the Financial Industry Regulatory Authority ("**FINRA**"), in response to a December 2009 letter from Andrew J. Donohue, Director of the Division of Investment Management at the SEC, has indicated its intention to propose rules banning improper pay-to-play practices by registered broker dealers (Donohue's letter is discussed in the ***March 9, 2010 Investment Management Regulatory Update***).

We discuss each of these developments below.

Guilty plea by former Chief Investment Officer for the New York State Comptroller

Loglisci pleaded guilty to a felony violation of New York State's Martin Act for his role in pay-to-play practices involving the NYCRF. Loglisci's position as CIO of the OSC allowed him to direct the NYCRF's investment activities, and in connection with his March 10, 2010 guilty plea, Loglisci admitted that on numerous occasions he recommended investments for the NYCRF not on the basis of their merit but instead based on political considerations dictated by Henry "Hank" Morris, a political adviser to Alan Hevesi, who was the New York State Comptroller at the time. According to Loglisci, among other things, he allowed Morris to pre-screen certain potential investments and to determine the composition of NYCRF's alternative investment portfolio. Morris allegedly used this authority to direct NYCRF monies to

advisers that either contributed to Hevesi's campaign or agreed to pay certain fees to Morris or his cronies.

Loglisci stands to be sentenced to up to four years in prison and has agreed to cooperate with the Office of the New York State Attorney General in its continuing investigation.

In announcing Loglisci's guilty plea, Attorney General Cuomo noted that the case demonstrates the need for "dramatic reform." In the absence of such reform, according to Cuomo, the NYCRF is "vulnerable . . . to graft and exploitation."

FINRA responds to SEC letter requesting regulation of pay-to-play practices of broker dealers

Responding to Donohue's December 2009 letter, Richard G. Ketchum, the Chairman and Chief Executive Officer of FINRA, noted in a March 15, 2010 letter that FINRA would move forward with promulgating rules that would implement a "regulatory scheme targeting improper pay-to-play practices by broker-dealers." Donohue's letter indicated that if FINRA were to ban pay-to-play activities by registered broker-dealers, the SEC could exclude them from its proposed blanket ban on the solicitation of government pension plan business by placement agents. In crafting the new rules, Ketchum expressed FINRA's intent to work closely with the SEC to ensure that any promulgated rules on the subject matter "are completely consistent."

We will continue to monitor developments pertaining to pay-to-play investigations and regulations.

- See a copy of the press release from the Office of the New York Attorney General
- See a copy of FINRA's letter to the SEC

Connecticut Lawmakers Propose Requiring Greater Disclosure from Advisers to Hedge Funds

Connecticut legislators recently proposed a bill that would require new conflict of interest disclosures from investment advisers to hedge funds located in Connecticut. The bill, "An Act Concerning Transparency and Disclosure," would apply to investment advisers of any hedge fund that has an office in the state of Connecticut where employees regularly conduct business on the fund's behalf. Such investment advisers would be required to disclose to investors and prospective investors any interest of the adviser, financial or otherwise, that conflicts with or is likely to impair the adviser's duties and responsibilities to the fund or its investors. Under the bill, the conflict of interest disclosure must take place, at a minimum, 30 days prior to any investment.

For purposes of the bill, a hedge fund is defined to be any fund (1) that would be an investment company but for the exemptions contained in Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940; (2) whose securities are offered pursuant to Rule 506 of Regulation D of the Securities Act of 1933; and (3) that meets any additional criteria that the Connecticut Banking Commissioner may establish in connection with implementing the bill's provisions.

- See a copy of the proposed legislation

SEC Rules and Regulations

SEC Publishes Guidance on the Custody Rule

The staff of the SEC's Division of Investment Management (the "**Staff**") has released updated responses to frequently asked questions ("**FAQs**") about Rule 206(4)-2 (the "**Custody Rule**") under the Investment Advisers Act of 1940 (the "**Advisers Act**"). The FAQs, which represent the views of the Staff, offer guidance on various issues relating to the Custody Rule, including the amendments to the rule adopted on December 30, 2009 and described in the ***January 7, 2010 Investment Management Regulatory Update***.

Some of the specific guidance provided by the FAQs is summarized below.

Delivery of Account Statements

The Custody Rule generally requires that registered investment advisers with custody over client assets establish a reasonable belief that the client's qualified custodian delivers account statements directly to the client.

While the compliance date for this requirement was March 12, 2010, the Staff offers some relief to advisers that have omnibus account arrangements with qualified custodians. In particular, the FAQs state that if certain conditions are met, the Staff will not recommend enforcement action against an adviser that is converting an omnibus account arrangement to meet the new requirements. The adviser must become compliant with respect to these accounts by the delivery of account statements for the third quarter of 2010. In addition, such an adviser must undergo a surprise examination for 2010 and communicate to each client the manner by which the adviser intends to modify the account arrangement to comply with the Custody Rule as well as the anticipated timing of such changes. **(Q.I.1, 2)**

The FAQs also note that account statements required by the Custody Rule may be delivered electronically, provided that certain conditions are met. In particular, the client must consent to electronic delivery, the client must be able to effectively access the electronically delivered information and the adviser must receive evidence of delivery. The Staff clarifies that in situations where clients receive electronic statements from qualified custodians, the adviser to such clients must still form a reasonable belief, after due inquiry, that the clients are receiving these statements. Although not limiting the manner in which an adviser may form such a reasonable belief, the Staff notes that one potential avenue would be for the adviser to be copied on e-mail notifications sent to clients and to possess access to clients' statements on the custodian's website. **(Q.IV.1)**

Surprise Examinations

For certain clients, subject to exceptions, the Custody Rule requires registered investment advisers with custody of client assets to undergo an annual surprise examination by an independent accountant.

The FAQs clarify that the surprise examination must commence by December 31, 2010, but does not need to be completed until 120 days after the time chosen by the examining accountant. In circumstances where the adviser itself (or presumably, although not stated in the FAQ, one of its related persons) maintains client assets as qualified custodian, the timing of the first surprise examination is tied to when the adviser obtains the required internal control report. Specifically, the first surprise examination must commence no later than six months after the internal control report is obtained. The FAQs also note that if an adviser becomes subject to the Custody Rule after March 12, 2010, its surprise examination must commence within six months of the adviser becoming subject to the rule. However, the Staff states that it will not recommend enforcement actions if such an adviser either has its first surprise examination commence within six months after becoming subject to the rule or by December 31, 2010, whichever is later. **(Q.I.3)**

The FAQs also note that an accounting firm that otherwise satisfies the definition of the term "independent public accountant" is not precluded from serving as an independent public accountant with respect to the surprise examination of an adviser—even where it regularly audits the advisory firm's books or the books of a limited partnership managed by the advisory firm. **(Q.IV.3)**

The Audit Provision

An exemption is available from the surprise examination requirements (described above) for registered investment advisers to pooled vehicles who obtain an annual audit of such pooled vehicles and who cause audited financial statements prepared in accordance with U.S. generally accepted accounting principles to be distributed to pool investors in accordance with the Custody Rule (the "**Audit Provision**"). In order to rely on this exemption, advisers are required to engage an accountant registered with, and regularly examined by, the Public Company Accounting Oversight Board (the "**PCAOB**").

The FAQs note, among other things, that the financial statements prepared in connection with the Audit Provision must, with certain exceptions for non-U.S. funds and non-U.S. advisers, be prepared in accordance with U.S. generally accepted accounting principles, while, without exception, the audit must meet the requirements of U.S. generally accepted auditing standards. (**Q.VI.3, 4)**

Additionally, the FAQs assert that the Audit Provision is available only where the client is a pooled investment vehicle. For other clients, including endowments, individuals and pension funds, the Audit Provision is not available, regardless of whether the client co-invests alongside a pooled investment vehicle that does utilize the Audit Provision. **(Q.X.1)**

For an investment adviser relying on the Audit Provision with respect to a pooled investment vehicle, the FAQs address certain consequences of the pooled vehicle failing to distribute its audited financial statements within 120 days after its fiscal year ends. The Staff notes that it would not recommend enforcement action if the adviser reasonably believed that within the 120-day period the pool's audited financial statements would be distributed, but such a distribution failed to occur in time due to unforeseeable circumstances. **(Q.VI.7)**

Additionally, the FAQs provide added guidance for funds of funds relying on the Audit Provision. The FAQs note that, pursuant to an existing no-action letter, the Staff would not recommend enforcement action if an adviser relying on the Audit Provision for a fund of funds distributes the audited financials to investors within 180 days from the end of the fund of funds' fiscal year. **(Q.VI.5)**

For an adviser to a limited partnership that does not undergo an annual audit, the Custody Rule requires that privately offered securities owned by the limited partnership be maintained with qualified custodians. However, acknowledging that "[s]ome of these securities . . . are recorded only on the books of their issuers that are not qualified custodians," the FAQs clarify that, in such circumstances, the adviser may satisfy its obligations by either maintaining an original of the signed subscription agreement with a qualified custodian or by having the custodian act as nominee for the limited partnership. **(Q.VII.2)**

Internal Controls Report

Under the Custody Rule, investment advisers who do not use an independent qualified custodian (i.e., those advisers who self-custody or for whom a related person serves as a qualified custodian) are required to obtain—or receive from a related person, as applicable—an annual review of internal controls related to their custodial operations.

The FAQs note that, for advisers subject to the requirement on March 12, 2010, the compliance date for obtaining an internal control report is September 12, 2010. However, the FAQs clarify that the internal control report need not address the effectiveness of controls over custodial services prior to March 12, 2010. For advisers that have become or will become subject to this requirement after March 12, 2010, the internal control report must be obtained within six months of becoming subject to the requirement. **(Q.I.7, 8)**

Inadvertent Receipt of Securities

The FAQs also address a situation in which an adviser inadvertently receives securities from a client. The Staff advises that the adviser may not forward the inadvertently received securities to the qualified custodian, but must instead return the securities to the sender within three business days. A failure to return the securities within this time frame will result in the adviser having custody of the securities and being in violation of the requirement that client securities be maintained with a qualified custodian. Despite this guidance, the Staff reaffirms earlier no-action relief that provided that, under certain circumstances, the Staff would not recommend enforcement action against an adviser that inadvertently received and, within five business days of its receipt, forwarded to the client or a qualified custodian the following: tax refunds, client settlement proceeds from administrators in connection with certain legal actions, or stock certificates, dividends, or evidence of new debt from issuers in connection with class action lawsuits involving bankruptcy or business reorganization. In such circumstances, the adviser would, however, be required to maintain appropriate records. **(Q.II.1)**

The FAQs address numerous other items, and the Staff has noted that it expects to update the FAQs from time to time.

- See the FAQs

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact

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