Davis Polk
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Investment Management Regulatory Update

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SEC Rules and Regulations

SEC Adopts Amendments to the Custody Rule

On December 30, 2009, the SEC released amendments to the "**Custody Rule**," *i.e.*, Rule 206(4)-2, and related forms and rules under the Investment Advisers Act of 1940 (the "**Advisers Act**"). The Custody Rule requires an SEC-registered investment adviser with custody of client funds and securities to take specific measures to safeguard these assets from loss, theft or misappropriation. These measures include, subject to certain exceptions, maintaining client assets with a "qualified custodian" that the adviser has a reasonable basis to believe provides account statements directly to the adviser's clients. The adopted amendments (the "**Final Rules**") are based upon those originally proposed in May 2009. See the ***June 8, 2009 Investment Management Regulatory Update*** for an overview of the amendments as proposed.

SEC Chairman Mary L. Schapiro noted at the SEC's December 16, 2009 open meeting (the "**Open Meeting**"), at which the Commissioners voted unanimously to adopt the Final Rules, that the Commission had "fine-tuned" the modifications to the Custody Rule in order to apply enhanced protections where they are most needed. The adopting release with respect to the Final Rules indicates, however, that the SEC considers the Final Rules merely a "first step" in efforts to strengthen investor protection in this area. Indeed, several SEC Commissioners emphasized at the Open Meeting that the adoption of the Final Rules would not preclude further rulemaking efforts in the area of custody and protection of investor assets.

In a companion release to the Final Rules adopting release, the SEC has provided updated guidance for accountants relating to the conduct of surprise examinations and preparation of internal control reports.

A summary of certain notable aspects of the Final Rules, a comparison of the Final Rules to the amendments as proposed and a list of certain key compliance dates follow.

Notable Provisions of the Final Rules

- *Surprise examinations*. Subject to certain exceptions, the Final Rules require registered investment advisers with custody of client assets to undergo an annual surprise examination by an independent accountant intended to verify the existence of such assets. The accountant conducting the surprise examination must notify the SEC within one business day if the surprise examination yields "material discrepancies," a requirement that is intended to provide the SEC with prompt notice of fraud. The accountant must also file with the SEC a certificate on Form ADV-E within 120 days of the time chosen by the accountant for the surprise examination and must make additional filings with the SEC in certain circumstances, including its resignation or other termination of its engagement.

  The Final Rules contain several exceptions to the surprise examination requirement not included in the original proposal. Among these is an exception for advisers who are deemed to have custody of client assets *solely* as a result of a related person's holding, directly or indirectly, client funds or securities (or having authority to obtain possession of them in connection with advisory services provided by the adviser).[1] In such cases, a surprise examination is not required under the Final Rules if the adviser can demonstrate that it is "operationally independent" of the affiliated custodian. The Final Rules establish a presumption that a related person custodian is not operationally independent, but allow an adviser to rebut the presumption, and set out several conditions that must be met in order to do so. An adviser must maintain a written memorandum explaining the basis for a determination that it has overcome the presumption.

  Also exempted from the surprise examination requirements are 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 generally accepted accounting principles to be distributed to pool investors in accordance with the Custody Rule (the "**Annual Audit Requirement**"). In order to rely on such exception, advisers are required to engage an accountant registered with, and regularly examined by, the Public Company Accounting Oversight Board (the "**PCAOB**"). An additional set of audited financial statements is required to be prepared and distributed upon the liquidation of the pooled vehicle. In explaining the rationale for this exemption, the SEC agreed with several commenters, including Davis Polk & Wardwell LLP ("**Davis Polk**"), that a surprise examination would not significantly benefit investors in a pool already subject to an annual financial statement audit. It should be noted, however, that if, for example, an adviser manages a separate account for a client to which the Annual Audit Requirement does not apply, the adviser would be subject to surprise examinations as well as account statement and delivery requirements described below with respect to the separate account.

  A third exemption from the surprise examination requirement is available under the Final Rules for advisers who use an independent custodian and are deemed to have custody over client assets *solely* as a result of their ability to deduct advisory fees from client accounts, based upon the SEC's conclusion that such arrangements do not give rise to the same risks of fraud and misappropriation as other forms of custody. This exemption is available to advisers that use

[1] The Final Rules modify the existing definition of the term "custody" to provide that an adviser will have "custody" of client assets if, among other things, "a related person holds, directly or indirectly, client funds or securities, or has any authority to obtain possession of them." The SEC has withdrawn no-action letters to the extent they are inconsistent with this amended definition of "custody."

qualified custodians that are related persons of the adviser, so long as the requirements of operational independence described above are met.

In addition, the Final Rules eliminate a previously existing provision which had exempted certain privately offered securities from the scope of surprise examinations. Privately offered securities are now required to be covered by surprise examinations.

- *Direct delivery of account statements by qualified custodians*. The Final Rules require that registered investment advisers with custody over client assets establish a reasonable belief, based upon due inquiry, that the client's qualified custodian delivers account statements directly to the client, regardless of whether an adviser submits to an annual surprise examination. The SEC believes that the direct delivery requirement will provide heightened comfort regarding the integrity of client account statements and the opportunity for clients to compare statements provided by the adviser and those provided by the qualified custodian. The Final Rules provide advisers flexibility in determining the method for conducting "due inquiry" in order to comply with this requirement. In addition, the Final Rules also mandate that certain notices and account statements delivered to clients by advisers contain legends urging clients to compare statements received from the custodian with those received from the adviser.

  To the extent that an adviser complies with the Annual Audit Requirement with respect to pooled vehicles it advises, it will not be required to comply with these account statement delivery and legend provisions.

- *Internal control report*. Under the Final Rules, all 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) will be required to obtain or receive from a related person an annual review of internal controls related to their custodial operations. An independent accountant registered with and regularly inspected by the PCAOB must perform such review and prepare a written report which describes such custodial controls and reports on their operating effectiveness.[2] An adviser must comply with the requirement to obtain or receive an internal control report regardless of whether or not it can demonstrate that its affiliated custodian is operationally independent of it.

- *Amendments to Form ADV and ADV-E*. The Final Rules include several modifications to Form ADV-E and Part 1A and Schedule D of Form ADV. The changes to Form ADV require more detailed reporting of information relating to advisers' custodial arrangements. Changes to Form ADV-E include modifications to reflect new requirements relating to the filing of certificates in connection with surprise examinations and terminations of accountant engagements.

- *Compliance policies*. While emphasizing its expectation that advisers will tailor their compliance policies to reflect their specific businesses, the SEC provides in the adopting release relating to the Final Rules several example policies and procedures that it believes advisers with custody over client assets should consider adopting.

Comparison to Proposed Amendments

Compliance with the Final Rules will likely prove significantly less burdensome than the originally proposed amendments. Commissioner Kathleen L. Casey expressed her belief at the Open Meeting that the Final Rules "better calibrate[]" the SEC response to recent high profile frauds than some of the originally proposed measures.

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[2] If the adviser or a related person serves as qualified custodian for client assets, the accountant performing the surprise examination with respect to such assets must also be registered with, and subject to regular inspection by, the PCAOB.

The inclusion in the Final Rules of certain exemptions which were not contained in the proposed amendments (*e.g.*, the exceptions from the surprise examination requirement for advisers who are deemed to have custody solely as a result of a related person's having custody of client assets or the adviser's ability to deduct fees) reflects the SEC's conclusion that not all custodial arrangements present equal risk of client assets being misused.

Further, the proposing release had requested comment on the advisability of a ban on the use of affiliated custodians. While the SEC stated in the adopting release its belief that the Final Rules will "encourage the use of independent custodians," it has not mandated such a result and has noted, along with several commenters, including Davis Polk, the negative consequences that such a measure might have, including with respect to the availability to investors of certain products such as wrap-fee programs.

Key Compliance Dates

The Final Rules will become effective on March 12, 2010 (the "**Effective Date**").

- *Client notifications/direct delivery of account statements*. Immediately upon the Effective Date, advisers must comply with applicable requirements relating to client notification of custody arrangements (including with respect to prescribed legends to be contained in such notices) and, if applicable, have a reasonable belief that a qualified custodian sends account statements to clients in accordance with the Final Rules.
- *Surprise examinations*. Advisers to whom the surprise examination requirements apply are generally required to enter into a written agreement that provides that the first examination will take place by December 31, 2010 (or, with respect to advisers that become subject to such requirement after the Effective Date, within six months of so becoming subject). However, if the adviser serves as its own qualified custodian, the agreement must provide for the first examination no later than six months after the internal control report is obtained.
- *Internal control reports*. Advisers subject to the requirement to obtain or receive an internal control report must obtain or receive such report within six months of becoming subject to the requirement.
- *Annual audit for pooled vehicles*. In order for advisers to pooled vehicles to comply with, or be exempted from, certain provisions of the Final Rules by virtue of their compliance with the Annual Audit Requirement, such advisers (or a related person) must become contractually obligated to obtain an audit that meets the requirements of the Final Rules for fiscal years beginning on or after January 1, 2010.
- *Form ADV.* All SEC-registered advisers must provide responses to the revised Form ADV in their first annual amendment after January 1, 2011.

- See a copy of the SEC release setting forth the Final Rules
- See a copy of the SEC companion release containing guidance with respect to the surprise examination and internal control report requirements
- See a copy of Davis Polk's comment letter to the SEC

SEC Extends Expiration Date for Temporary Rule on Principal Trades with Certain Advisory Clients

On December 23, 2009, the SEC adopted as final temporary Rule 206(3)-3T under the Investment Advisers Act of 1940 (the "**Advisers Act**"), extending its expiration date by one year but otherwise leaving the substantive content of the rule the same as that adopted on an interim final basis in 2007. As described in the ***October 2007 Investment Management Regulatory Update***, Rule 206(3)-3T establishes an alternative means for investment advisers who are registered with the SEC as broker-dealers to satisfy the requirements of Section 206(3) of the Advisers Act when they act in a principal capacity in transactions with certain of their advisory clients. Absent further action by the SEC, Rule 206(3)-3T will now sunset on December 31, 2010 instead of December 31, 2009. While the rule continues to be in effect, the SEC will consider whether to propose continuing the rule beyond the revised sunset date and, if so, whether modifications to the rule might be appropriate.

- See a copy of the final temporary rule

SEC Adopts Rule Amendments Requiring Increased Disclosure Regarding Leadership of Registered Management Investment Companies

Spurred by what it characterized as investors' increased interest in and demand for information pertaining to "corporate accountability," on December 16, 2009, the SEC adopted various rule amendments that, among other things, will require registered management investment companies ("**funds**") to disclose additional information about the structure of their boards and their board members' qualifications and backgrounds.

Specifically, Forms N-1A, N-2 and N-3 will be amended to require additional disclosure regarding the fund's board leadership structure and an analysis of whether that leadership structure (*i.e.*, whether and why it has chosen to combine or separate the principal executive officer ("**PEO**") and board chair positions) "is appropriate given the specific characteristics or circumstances" that pertain to it. If a fund's PEO and chair are combined, then the fund is required to disclose whether the fund's board has a lead independent director or trustee and, if so, the specific role the lead director or trustee plays in the leadership of the board. The registration forms, as amended, will also require a fund to disclose: (i) the role that its board or a committee plays in overseeing the fund's risk management practices (with respect to credit, liquidity, operational, investment, compliance and valuation risks); and (ii) information pertaining to each of its director's or trustee's service on the board of another public company or fund during the past five years. Finally, a fund will need to specify, for each of its directors or trustees, "the experience, qualifications, attributes, or skills" that justify that person serving as a director or a trustee for the fund.

Additionally, pursuant to the rule amendments, the proxy statement of a fund (where action is to be taken with respect to the election of directors or trustees) will need to contain the foregoing, and other, disclosures with respect to all of the fund's directors or trustees, regardless of whether they are up for reelection, and all of its nominees. Notably, funds' proxy statements will also have to disclose whether its directors or trustees, nominees or executive officers have been involved in certain, specified legal proceedings during the past 10 years and whether and how the board's nominating committee considers diversity in choosing nominees for a directorship.

The amendments are scheduled to become effective on February 28, 2010.

- See a copy of the SEC release adopting the amendments

Revisions to Regulation D on the SEC's Regulatory Agenda

The SEC's semiannual regulatory agenda (the "**Agenda**") was published in the Federal Register on December 7, 2009. The agenda identifies rules that the SEC expects to consider in the next 12 months that are likely to have a significant impact on a substantial number of small entities. Among other things, the Agenda notes that the SEC is withdrawing proposed revisions to Regulation D under the Securities Act of 1933 (the "**Securities Act**"), which were previously offered by the SEC on August 3, 2007, as reported in the ***September 2007 Investment Management Regulatory Update***. The withdrawn rule proposal would have, among other things, revised the "accredited investor" definition and provided an exemption from the registration requirements of the Securities Act for offers and sales of securities to "large accredited investors." The Agenda also indicates that the SEC's Division of Corporate Finance may recommend new revisions to Regulation D, including revisions to the accredited investor eligibility standards.

- See a copy of the Agenda
- See a copy of the withdrawn SEC proposed rules

Industry Update

Private Fund Investment Advisers Registration Act Included in Sweeping Financial Reform Legislation Passed by the House of Representatives

On December 11, 2009, the House of Representatives approved the Wall Street Reform and Consumer Protection Act (H.R. 4173), which passed by a vote of 223-202, and includes as Title V, Subtitle A, the Private Fund Investment Advisers Registration Act (the "**PFIARA**"). The PFIARA generally follows the legislative proposal that was approved by the House Financial Services Committee on October 27, 2009 (the "**Committee Version**"), as reported in the ***November 11, 2009 Investment Management Regulatory Update***.

The debate over increased regulation of investment advisers to private funds now shifts to the Senate, where corresponding financial reform legislation introduced by Senator Christopher J. Dodd (D-CT) on November 10, 2009 contains a title styled "Regulation of Advisers to Hedge Funds and Others" (the "**Dodd Title**") that seeks to accomplish similar goals as the PFIARA. See the ***December 4, 2009 Investment Management Regulatory Update*** for an overview of the Dodd Title.

This update will summarize certain key provisions of the PFIARA, comparing them to corresponding provisions in the Dodd Title.

The PFIARA, like the Dodd Title, eliminates the "private investment adviser" registration exemption contained in Section 203(b)(3) of the Investment Advisers Act of 1940 (the "**Advisers Act**"), which is currently relied upon by many investment advisers, including those to private funds. In the absence of this exemption, nearly all advisers to private funds would be required to register with the SEC. The PFIARA defines a "private fund" as a 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. This definition differs from that contained in the Dodd Title, which would capture such a fund only if it were also created under U.S. laws or if 10% or more of its securities were owned by U.S. persons. Under both the PFIARA and the Dodd Title, the "private fund" definition ties to other provisions of the bill, including certain books and records and reporting requirements.

The PFIARA provides exemptions from registration to:

- foreign private fund advisers, meaning those advisers with, among other things, no place of business in the United States and, for the preceding 12 months, fewer than 15 clients and investors in the United States in private funds and aggregate assets under management attributable to clients and investors in the United States in private funds of less than $25 million;
- investment advisers to "venture capital funds";
- investment advisers that act solely as an adviser to private funds and have cumulative assets under management in the United States of less than $150 million; and
- investment advisers to licensed small business investment companies.

The Dodd Title also provides certain exemptions from registering with the SEC, although these exemptions differ, in part, from those provided by the PFIARA. While both the PFIARA and the Dodd Title provide registration exemptions to certain foreign investment advisers and advisers to venture capital funds, the Dodd Title provides an additional registration exemption to investment advisers to private equity funds and excludes "family offices" entirely from the Advisers Act's definition of the term "investment adviser." The Dodd Title does not exempt investment advisers to small business investment companies, nor does it exempt advisers that advise only private funds and have cumulative assets under management in the United States of less than $150 million.

The PFIARA explicitly notes that investment advisers to venture capital funds and investment advisers that act solely as an adviser to private funds and have cumulative assets under management in the United States of less than $150 million are, despite being exempt from SEC registration, subject to recordkeeping and reporting requirements to be determined by the SEC. Under the Dodd Title, investment advisers to private equity funds, but not advisers to venture capital funds, would be required to maintain certain records and make annual reports to the SEC.

In addition to the foregoing registration requirements, the PFIARA, like the Dodd Title, establishes a framework for recordkeeping, reporting and information collection and sharing. Under the PFIARA, registered investment advisers would be required to maintain records and file reports with the SEC for each private fund that they advise. The records of these private funds would be subject to periodic and special examination by the SEC and would need to detail, at a minimum, information regarding each fund's assets under management, use of leverage, counterparty credit risk exposure, trading and investment positions and trading practices. The Dodd Title would require additional disclosure of information not called for under the PFIARA, including any side arrangements or side letters entered into by each private fund.

Under the PFIARA's provisions, it would be permissible for the SEC to share information filed with or provided to it with certain other regulators, including the Board of Governors of the Federal Reserve System. Generally, such information would be treated as confidential. The Dodd Title contains substantively similar information-sharing provisions.

In contrast to the Dodd Title, the PFIARA would grant the SEC the authority to require registered investment advisers to provide reports, records and other documents to investors, prospective investors, counterparties and creditors of any private fund advised by that adviser. In conjunction with this public disclosure authority, the PFIARA does specify that a fund's proprietary information would be protected from disclosure to its counterparties and creditors.

The differences between the PFIARA and the Dodd Title noted above draw attention to some of the issues that need to be resolved before these proposed reforms become law.

For an overview of the contents of the House financial reform legislation, including the PFIARA, please see the Davis Polk client memorandum ***Summary of the Wall Street Reform and Consumer Protection Act***.

Extension of Temporary Stock Dividend Rules for Publicly Traded RICs and REITs

The Internal Revenue Service (the "**IRS**") has extended for two years the temporary stock dividend rules for publicly traded regulated investment companies ("**RICs**") and real estate investment trusts ("**REITs**") that it announced in late 2008 and early 2009. Promulgated to address liquidity issues attributable to the economic crisis, these rules treat certain *pro rata* stock distributions as dividends for U.S. federal income tax purposes, thus enabling publicly traded RICs and REITs to satisfy applicable distribution requirements while retaining cash. The special rules now apply to distributions with respect to taxable years ending on or before December 31, 2011.

In general, a RIC or REIT deducts the dividends it pays, and thereby avoids corporate-level tax on distributed income, provided that it distributes at least 90% of its income, other than certain types of income, each year. The dividends-paid deduction is available only with respect to distributions that are treated as dividends for U.S. federal income tax purposes and that are not "preferential" to any shareholder. A *pro rata* distribution of the distributing corporation's stock is generally not treated as a dividend for U.S. federal income tax purposes, but a stock distribution generally will be treated as a dividend to the extent that it is made out of earnings and profits if any shareholder may elect to receive the distribution either in stock or in cash.

The earlier guidance, set forth in Revenue Procedures 2008-68 and 2009-15, provided that stock distributions made by a publicly traded RIC or REIT would be treated as dividends if, among other things, (i) each shareholder could elect to receive the dividend either in money or in stock of the distributing corporation, subject to an overall limitation on the amount of money to be distributed in the aggregate to all shareholders; (ii) the amount of money to be distributed was at least 10% of the aggregate declared distribution; and (iii) the calculation of the number of shares to be received by any shareholder was made so as to equate the value of those shares with the amount of money that would otherwise have been received by the shareholder. The earlier guidance also required that, if the shareholders elected to receive more money than the total amount of money to be distributed, each electing shareholder would receive a *pro rata* portion of the money, and no electing shareholder would receive less than 10% of his or her distribution in money. Stock distributions that met these requirements were treated as dividends for purposes of both the dividends-paid deduction and the treatment of the shareholders. These special stock dividend rules applied to distributions with respect to a taxable year ending on or before December 31, 2009.

Like the earlier guidance, Revenue Procedure 2010-12, which was issued on December 23, applies only to publicly traded RICs and REITs. It extends the application of the earlier guidance with some additional criteria:

- It provides that if different shareholders receive different combinations of stock and money, and if the fair market value of the stock on the date of distribution differs from the amount of money that would otherwise have been distributed, those differences will not cause the distribution to be a "preferential" dividend (*i.e.,* a non *pro-rata* dividend) for which the dividends-paid deduction is not available.
- While the earlier guidance required that the calculation of the number of shares to be distributed be made as close in time as practicable to the dividend payment date, Revenue Procedure 2010-12 specifies that this calculation must be made over a period of up to two weeks ending as close as practicable to the payment date.
- Revenue Procedure 2010-12 explicitly addresses the rules under which certain dividends paid by a RIC or REIT after the end of its taxable year will be treated, for purposes of the dividends-paid deduction, as paid during the taxable year. It applies to qualifying distributions declared on or before December 31, 2012, with respect to a taxable year ending on or before December 31,

2011, whether declared and distributed prior to the close of the taxable year or pursuant to one of these provisions.

- See a copy of IRS Revenue Procedure 2010-12

Proposed Legislative Changes to the RIC Rules

On December 16, 2009, Rep. Charles Rangel (D-NY), chairman of the House Ways and Means Committee, introduced proposed legislation -- H.R. 4337, the Regulated Investment Company Modernization Act of 2009 -- that would make a number of changes to the rules applicable to regulated investment companies ("**RICs**"). If enacted, this legislation would generally broaden the application of certain favorable provisions of the RIC rules and ease certain compliance burdens. Most significantly, it would expand the definition of "qualifying income" to include income from investments in commodities.

A corporation will qualify as a RIC for any taxable year only if at least 90% of its income consists of "qualifying income." Under current law, investments in commodities other than foreign currencies do not give rise to "qualifying income." In 2006, the Internal Revenue Service (the "**IRS**") issued a revenue ruling concluding that income and gain derived from a derivative contract (a total return swap) that referenced a commodity index did not constitute "qualifying income" because the derivative was not a "security."[3] Subsequently, the IRS issued a number of private letter rulings concluding that commodity-linked notes give rise to "qualifying income" because the notes, while hybrid instruments, are predominantly securities.[4] The IRS has also ruled that income derived by a RIC from a wholly owned foreign subsidiary that invests in commodities constitutes "qualifying income."[5]

The proposed legislation would put an end to this strained analysis by including in "qualifying income" a RIC's gains from the sale or other disposition of commodities, as well as other income derived by a RIC with respect to its business of investing in commodities. Because investments in commodities, including foreign currencies, would give rise to "qualifying income" under the new provision, the proposed legislation would also repeal the current regulatory authority given to the Treasury Department to exclude from "qualifying income" foreign currency gains that are not directly related to a RIC's principal business of investing in stock and securities or options and futures with respect to stock or securities.

Among the other proposed changes to the RIC rules are the following:

- For "publicly offered" RICs, the new legislation would repeal the rule that "preferential" (non-pro rata) dividends do not give rise to a dividends-paid deduction. The repeal would facilitate mechanisms under which different shareholders could bear different percentages of RIC-level fees and expenses. A RIC would be treated as "publicly offered" for this purpose if its shares were (1) continuously offered pursuant to a public offering, (2) regularly traded on an established securities market or (3) held by no fewer than 500 persons at all times during the taxable year.
- Under current law, a redemption of stock by a corporation is treated as a sale or exchange if the redemption meets certain criteria, and otherwise is treated as a distribution of property. Under the proposed legislation, any distribution in redemption of stock of an open-end, "publicly offered" RIC would be treated as a sale or exchange, rather than as a dividend.

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[3] Rev. Rul. 2006-1, 2006-1 C.B. 261, *modified and clarified by* Rev. Rul. 2006-31, 2006-1 C.B. 1133. "Qualifying income" includes dividends, interest, gains from the sale or other disposition of stock or securities (as defined in section 2.(a)(36) of the Investment Company Act of 1940, as amended) or foreign currencies, or other income derived with respect to the RIC's business of investing in such stock, securities or foreign currencies.

[4] *See, e.g.*, Priv. Ltr. Rul. 200952019 (Sept. 13, 2009); Priv. Ltr. Rul. 200822012 (Feb. 12, 2008); Priv. Ltr. Rul. 200705026 (Oct. 31, 2006); Priv. Ltr. Rul. 200701020 (Sept. 26, 2006); Priv. Ltr. Rul. 200647017 (Aug. 10, 2006); Priv. Ltr Rul. 200637018 (June 1, 2006); Priv. Ltr. Rul. 200628001 (Apr. 10, 2006).

[5] *See, e.g.*, Priv. Ltr. Rul. 200936002 (May 26, 2009); Priv. Ltr. Rul. 200932007 (Apr. 29, 2009).

- A “qualified fund of funds” would be permitted to pass underlying funds’ foreign tax credits and tax-exempt interest through to its shareholders. Under current law, a RIC may distribute exempt-interest dividends only if at least 50% of the value of its assets consists of tax-exempt obligations, and may pass through foreign tax credits only if more than 50% of the value of its assets consists of stock or securities of foreign corporations. A RIC that invests principally in other RICs does not meet these tests. For purposes of the new provision, a RIC will be a “qualified fund of funds” (and thus entitled to pass through tax-exempt interest and foreign tax credits) if at least 95% of the value of its assets consists of cash, cash items and interests in other RICs.
- Under the proposed legislation, the generally applicable rule deferring the recognition of loss from the sale or exchange of property between members of a controlled group of corporations until the property is transferred outside the group would not apply to a RIC’s redemption of stock in a lower-tier open-end RIC.
- A corporation will qualify as a RIC for any taxable year only if it meets the “qualifying income” test described above and an asset diversification test. New “savings” provisions would mitigate the consequences of a RIC’s failure to satisfy the asset diversification and “qualifying income” tests for any taxable year. These rules would provide a special cure provision for *de minimis* asset test failures, as well as a mechanism under which a RIC could cure other asset test and “qualifying income” test failures through reporting and the payment of penalty taxes. In the case of an asset test failure, the penalty tax would not exceed $50,000; in the case of a “qualifying income” test failure, the penalty tax would be equal to the portion of the non-“qualifying” income that caused the RIC to fail the test.

The proposed legislation contains a number of additional provisions, including provisions that would simplify a RIC’s designation of the pass-through of certain items to its shareholders (including capital gain dividends, exempt-interest dividends, interest-related dividends and short–term capital gain dividends distributed to foreign persons, dividends that consist of “qualified dividend income,” dividends that may give rise to a dividends-received deduction for corporate shareholders and foreign tax credits); a provision that would revise the loss carryover rules for RICs to be similar to the current rules applicable to individuals; various provisions that would address the treatment of RICs with taxable years other than the calendar year; and several revisions to the rules governing the excise tax imposed on RICs that do not meet a calendar-year distribution requirement.

- See a copy of H.R. 4337

SEC Inspector General Recommends Changes to Process for Selecting Investment Advisers and Investment Companies for Examination

On November 19, 2009, the SEC’s Office of Inspector General (“**OIG**”) issued a final report entitled “Review of the Commission’s Processes for Selecting Investment Advisers and Investment Companies for Examination” (the “**Report**”).

The Report represents the culmination of OIG’s examination of the SEC’s failure to uncover the Ponzi scheme operated by Bernard Madoff. The Report observes that the SEC’s Office of Compliance Inspections and Examinations (“**OCIE**”) and Division of Enforcement (“**Enforcement**”) repeatedly examined and investigated Bernard Madoff Investment Securities, LLC (“**BMIS**”) and found that BMIS was operating as an unregistered investment adviser and that Bernard Madoff lied about BMIS’s advisory role. Despite these findings, the Report notes that OCIE issued a “medium” risk rating to BMIS and failed to examine BMIS after it finally registered as an investment adviser in 2006 in response to an Enforcement investigation.

Based on OIG's findings, which articulate various concerns with respect to the SEC's process for selecting investment advisers and investment companies for examination, the Report offers 11 recommendations, summarized below:

- The process for creating investment adviser risk ratings should include a procedure that requires OCIE to search relevant SEC databases containing information about past examinations, investigations and filings.
- Investment adviser risk ratings should be changed based on pertinent information garnered from all SEC divisions and offices, even if not obtained during an examination of a firm's investment advisory business.
- A joint protocol should be established to provide for information-sharing between OCIE and Enforcement.
- OCIE should establish a procedure to evaluate negative information about investment advisers that it receives and should use this information to determine whether a cause examination is appropriate and, if so, initiate one in a timely manner.
- When negative information about an investment adviser comes to light, OCIE should examine that investment adviser's Form ADV filings and both document and investigate discrepancies.
- OCIE should establish a procedure to evaluate the Form ADVs of an investment adviser upon becoming aware of issues or problems with that investment adviser.
- OCIE should document areas where it believes a Form ADV contains false information and initiate appropriate action.
- OCIE should reevaluate the point scores that it assigns to advisers based on their reported assets under management and number of clients and should assign progressively higher risk weightings to firms with greater assets under management and/or with a larger number of clients.
- OCIE should recommend an SEC rulemaking to require that Form ADV include additional information, including performance information and information about a fund's service providers, custodians, auditors and administrators.
- The SEC should, in consultation with OCIE and the Division of Investment Management, finalize a 2008 rule proposal that would update the information required to be included in Part II of Form ADV and require Part II of Form ADV to be filed with the SEC.
- OCIE should develop policies and procedures for conducting effective third-party verifications.

▸ See a copy of the OIG Report

Developments Regarding Pay-to-Play Practices

As previously reported in several *Investment Management Regulatory Update*s, including, among others, the ***November 11, 2009 Investment Management Regulatory Update***, pay-to-play practices have been, and continue to be, the focus 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 Elliott Broidy, a founder of the private equity firm Markstone Capital Group LLC ("**Markstone**"), as well as a settlement agreement with David Leuschen, the founder of the private equity firm Riverstone Holdings LLC ("**Riverstone**").

Broidy pleaded guilty to a felony count of rewarding official misconduct. He acknowledged giving nearly $1 million in gifts to OSC officials to secure a $250 million investment from the NYCRF in a fund managed by Markstone. Broidy has agreed to cooperate with the New York State Attorney General's office in its continuing investigation and, in connection with his plea, he has also agreed to forfeit $18 million, approximately the amount that the NYCRF paid Markstone in management fees. Broidy stands to be sentenced to four years in prison.

Leuschen reached a settlement agreement with the New York State Attorney General's office regarding its investigation into his role in pay-to-play practices involving the NYCRF. According to the New York State Attorney General, its probe revealed that after an investment of $150 million in a joint venture between the Carlyle Group and Riverstone, Leuschen contributed $100,000 to a film produced by the brother of David Loglisci, who, at the time, was the Chief Investment Officer to the New York State Comptroller, Alan Hevesi, the individual responsible for managing the NYCRF. According to the terms of the agreement with the New York State Attorney General's office, Leuschen is required to pay $20 million in restitution to the NYCRF.

In announcing his office's settlement agreement with Leuschen, Attorney General Cuomo pledged to "continue to pursue the critical reforms that are necessary to prevent such rampant abuse from again corrupting the pension system."

- See a copy of the press release announcing the Broidy plea
- See a copy of the press release announcing the agreement with Leuschen

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SEC Discusses its Regulatory Reform Agenda for 2010

On December 3, 2009, SEC Chairman Mary L. Schapiro delivered a speech addressing financial services regulatory reform at the Consumer Federation of America's Annual Financial Services Conference. Schapiro generally emphasized that current regulatory reform efforts "have a ways to go" and should, as far as the SEC is concerned, focus on protecting individual investors. To that end, Schapiro discussed the following reform proposals, among others.

Harmonization of Standard of Conduct for Securities Professionals

Schapiro argued that brokers and investment advisers should be subject to the same fiduciary duty, licensing and qualification standards, disclosure obligations and regulatory and recordkeeping requirements. According to Schapiro, individual investors do not generally discern or appreciate the difference between brokers and investment advisers; therefore, applicable SEC rules and regulations should no longer continue to make this distinction.

Point of Sale Disclosure

Schapiro also discussed the SEC's interest in improving the point of sale disclosures made to investors when they purchase securities, arguing that such disclosures should be "clear, simple, meaningful" and should make clear the compensation paid to the individual or firm selling the product. While acknowledging that designing these disclosure requirements will be a difficult task as securities products become increasingly complex, Schapiro lauded the strides already made by the SEC's staff in developing simplified disclosures for variable annuities, which she characterized as a complex product, and contended that it will be well worth the effort to roll out similar disclosure requirements for other products.

12b-1 Fees

Schapiro has requested that the SEC's staff provide recommendations in 2010 on reforming 12b-1 fees, which are marketing and distribution fees assessed on mutual funds. She noted that these fees were in excess of $13 billion in 2008 and that the SEC "must critically rethink how [they] are used and whether they continue to be appropriate."

Retirement Products

Schapiro has also requested that the SEC's staff provide recommendations on target date funds, a type of fund that automatically adjusts its asset allocation as some target date (*e.g.*, retirement) approaches. She indicated that the SEC will be focused on reforming the marketing and disclosure requirements for these funds.

Self-Funding

Lastly, Schapiro noted that, for the SEC to achieve its goals regarding regulatory reform, it will need additional funding. The SEC could receive this additional funding, Schapiro proposed, were it given the ability to fund its operations using the fees it collects, a funding approach utilized by other financial regulators.

- See the full text of Schapiro's speech

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