Davis Polk
CLIENT NEWSLETTER

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Investment Management Regulatory Update

Industry Update

Treasury Department To Develop Anti-Money Laundering Rules for Investment Advisers

In a speech given at the American Bankers Association/American Bar Association Money Laundering Enforcement Conference on November 15, 2011, James H. Freis Jr., the director of the Financial Crimes Enforcement Network ("**FinCEN**"), announced that FinCEN is again focusing on developing an anti-money laundering ("**AML**") rule for investment advisers as part of its efforts to "apply appropriate regulatory controls beyond the banking sector." According to Freis, FinCEN is currently working on a regulatory proposal that "would require investment advisers to establish AML programs and report suspicious activity" and would build on the changes to the investment adviser industry introduced by the Dodd-Frank Act. In this respect, Freis noted that FinCEN would work with the SEC and the states going forward.

Freis noted that FinCEN's current AML regulations cover broker-dealers and mutual funds, but that the Treasury Department is authorized to expand the definition of "financial institution" under the Bank Secrecy Act (the "**BSA**"), as amended by Title III of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (the "**PATRIOT Act**"), to apply to other types of entities that engage in activities similar to those of existing financial institutions. In addition to AML regulation of investment advisers, Freis spoke about the need for additional regulatory controls in other non-banking areas—namely, prepaid access, casinos, non-bank residential mortgage lenders and originators and the insurance industry—in order to maximize effectiveness and efficiency in mitigating the risk of money laundering and other financial crimes.

As discussed in the ***September 2002 Investment Management Regulatory Update*** and the ***June 2003 Investment Management Regulatory Update***, FinCEN initially proposed AML rules under the PATRIOT Act for unregistered investment companies in September 2002, and for commodity trading advisors and investment advisers in May 2003. Among other things, the rules would have required implementation of AML policies and procedures, designation of an AML compliance officer, ongoing AML employee training and independent testing of compliance with such policies and procedures. The proposed rules were never implemented, however, and, as discussed in the ***December 3, 2008 Investment Management Regulatory Update***, FinCEN withdrew them in October 2008, citing the passage of time as the main reason. Any new AML regulation covering investment advisers would be expected to include these same elements again.

We will continue to monitor developments in this area.

- See a copy of Freis' remarks

Proposed Treasury Regulations Clarify U.S. Taxation of Investments by Foreign Governments

On November 2, 2011, the Treasury Department released proposed revisions to the regulations under Section 892 of the Internal Revenue Code of 1986, which provide an exemption from U.S. federal income tax for certain types of U.S.-source investment income derived by foreign government entities, including sovereign wealth funds. The proposed revisions would make several modifications to the current regulations that would be favorable from the perspective of private investment funds and sovereign wealth funds investing in them, including introducing a new rule providing that, under certain circumstances, the commercial activities of a limited partnership are not attributable to its limited partners that are foreign government entities. The proposed regulations also would expand the categories of activities that are not considered "commercial," provide that an entity's status as a "controlled commercial entity" is determined annually, and provide relief from classification as a controlled commercial entity if an entity conducts only "inadvertent commercial activity."

Please see the ***November 3, 2011*** Client Newsflash for a more detailed discussion of the proposed Treasury regulations.

SEC Grants No-Action Relief to Mutual Fund Proposing to Transfer Assets to Affiliated Liquidating Trust

The SEC's Division of Investment Management (the "**Division**") recently issued a no-action letter to Morgan Stanley Institutional Fund of Hedge Funds LP ("**IFHF**"), a closed-end investment company registered under the Investment Company Act of 1940 (the "**Investment Company Act**") that invests substantially all of its assets in unregistered investment funds (the "**Underlying Funds**"). In its letter, the Division stated that it would not recommend enforcement action to the SEC under Section 17(a) or 17(d) of the Investment Company Act or Rule 17d-1 thereunder if IFHF transfers the interests in certain Underlying Funds to a newly-created liquidating trust and simultaneously distributes interests in such trust *pro rata* to all IFHF limited partners.

In order to provide periodic liquidity to its limited partners, IFHF typically engages in quarterly issuer tender offers, in accordance with Rule 13e-4 under the Securities and Exchange Act of 1934, equal to 5-25% of IFHF's total assets. To satisfy these tender offers, IFHF usually redeems interests in the Underlying Funds and distributes the cash received to tendering limited partners. Because certain Underlying Funds have suspended or severely restricted redemptions (the "**Illiquid Funds**"), IFHF grew worried that interests in such Illiquid Funds would become an increasingly large percentage of its total assets, causing the portfolio to become less diversified. To remedy this, IFHF proposed to transfer its interests in the Illiquid Funds to a liquidating trust managed by Morgan Stanley AIP GP LP, IFHF's investment adviser, in exchange for an interest in the liquidating trust, and then to distribute interests in the liquidating trust *pro rata* to each limited partner with a view to completely liquidating the interests in the Illiquid Funds.

Under Section 17(a) of the Investment Company Act, an affiliated person of a registered investment company ("**RIC**"), or any affiliate of such affiliated person (a "**second-tier affiliate**"), acting as principal, is prohibited from knowingly buying securities or other property from the RIC or selling securities or other property to the RIC, except in certain limited circumstances. Because the liquidating trust and IFHF would have the same investment adviser, IFHF noted that they could be viewed as being under common control and therefore as "affiliated persons." Accordingly, IFHF highlighted that, if the transfer of interests to the liquidating trust were considered to be a "purchase" or "sale" of securities or other property, Section 17(a) could be implicated, and similarly Section 17(a) could prohibit IFHF's distribution of interests in the liquidating trust to affiliated limited partners (*i.e.*, those that hold more than 5% of IFHF's interests and/or are under common control with IFHF). In addition, while IFHF noted that Rule 17a-3 under the Investment Company Act, which exempts from Section 17(a) transactions between a RIC and one or more fully-owned subsidiaries, would seem to apply to the transactions at issue, IFHF expressed concern that the rule might not be directly on point because IFHF would be simultaneously distributing out to limited partners its entire interest in the liquidating trust, rather than holding the interest itself. Similarly, IFHF was concerned that Rule 17a-5, which exempts from Section 17(a) *pro rata* distributions of portfolio securities by a RIC to its shareholders where the shareholders cannot elect what assets they will receive, might not apply given that the SEC staff had previously indicated that interests in a newly-formed limited partnership established to hold certain RIC assets may not constitute portfolio securities for purposes of the rule.

Section 17(d) of the Investment Company Act prohibits an affiliated person or second-tier affiliate of a RIC, acting as principal, from effecting any transaction in which the RIC is a joint or joint and several participant, in contravention of such rules and regulations as the SEC may prescribe for the purpose of limiting or preventing participation by the RIC "on a basis different from or less advantageous than that of such other participant." Rule 17d-1 generally prohibits "participation in any joint enterprise or other joint arrangement or profit-sharing plan" without prior approval of the SEC. Noting that establishing the liquidating trust and distributing out its interests to limited partners could be viewed as a joint arrangement among IFHF, the investment adviser, the liquidating trust and the affiliated limited partners within the meaning of Rule 17d-1, IFHF sought no-action relief.

In granting the relief requested, the Division focused on several factors cited by IFHF, including: (i) all of IFHF's interests in the Illiquid Funds as of December 31, 2010 would be transferred to the liquidating trust and would be valued using the same method used to calculate IFHF's net asset value; (ii) no limited partner would have a say in which Illiquid Funds would be transferred to the liquidating trust; (iii) the distribution of IFHF's interests in, and any cash from, the liquidating trust would be made to the limited partners on a *pro rata* basis; (iv) the investment adviser would not be entitled to receive any compensation for managing the liquidating trust's assets, and the general partner of IFHF waived its right to receive any performance-based incentive allocation for managing IFHF following the establishment of the liquidating trust; and (v) the creation of the liquidating trust and the accompanying distribution would be consistent with IFHF's policies. The Division also noted that, based on such factors, IFHF had concluded that the proposed transactions, "including the consideration to be paid or received, are reasonable and fair and do not involve overreaching on the part of any person concerned" and are consistent with the general purposes of the Investment Company Act, and that IFHF's participation in the proposed transactions would be "on a basis no less advantageous than that of other participants."

Notably, given the "very fact specific nature" of the request, the Division stated that the no-action letter "applies only to the named parties, and no other entity may rely on this position."

- See a copy of the no-action letter
- See a copy of the letter requesting no-action relief

Litigation

Federal District Court Imposes $92.8 million Civil Penalty on Hedge Fund Manager Raj Rajaratnam

On November 8, 2011, the U.S. District Court for the Southern District of New York granted summary judgment and imposed a civil penalty of approximately $92.8 million against Raj Rajaratnam, a principal at hedge fund advisory firm Galleon Management LP, in an insider trading case brought by the SEC. *SEC v. Rajaratnam, et al.*, No. 09 Civ. 8811 (S.D.N.Y. Nov. 8, 2011). As discussed in the ***November 11, 2009 Investment Management Regulatory Update***, the SEC charged Rajaratnam and others with trading on material, nonpublic information in violation of Section 10(b) of the Securities Exchange Act of 1934 (the "**Exchange Act**"), Rule 10b-5 thereunder and Section 17(a) of the Securities Act of 1933 (the "**Securities Act**").

Because Rajaratnam was convicted in a parallel criminal case in which he was sentenced, on October 13, 2011, to 11 years in prison, ordered to forfeit $53.8 million and fined $10 million in criminal penalties, Rajaratnam was estopped from contesting liability with respect to trading on the shares at issue, namely those of Intel Corp., Clearwire Corp., Akamai Technologies, Inc., ATI Technologies, Inc., and PeopleSupport, Inc. Section 21A of the Exchange Act authorizes civil penalties to be imposed against a person who commits insider trading based on the facts and circumstances of the case, in an amount up to "three times the profit gained or the loss avoided." The court disagreed with Rajaratnam's argument that civil penalties were unwarranted in light of the criminal penalties already imposed and, based on Rajaratnam's "net worth, which considerably exceeds the financial penalties imposed in the criminal case" and the "huge and brazen nature of Rajaratnam's insider trading scheme," concluded that "this case cries out for the kind of civil penalty that will deprive [him] of a material part of his fortune." The court accepted Rajaratnam's calculation of $30.9 million and imposed a penalty of three times such amount for a total of $92.8 million. According to an SEC press release, this "marks the largest penalty ever assessed against an individual in an SEC insider trading case."

In addition to the civil penalty, Rajaratnam is permanently enjoined from further violations of Section 10(b) of the Exchange Act, Rule 10b-5 thereunder and Section 17(a) of the Securities Act.

- See a copy of the court's opinion and order
- See a copy of the SEC's press release

SEC Settles with Advisory Firm for Improper Fees Paid to Mutual Fund Sub-Adviser

On November 16, 2011, the SEC issued an order settling charges that a registered investment adviser (the "**Adviser**") which serves as adviser to a closed-end registered investment company investing in Malaysian equity securities (the "**Fund**") misrepresented to the Fund's investors and board of directors (the "**Board**") that certain advisory services were being provided by a Malaysian sub-adviser (the "**Sub-Adviser**"). In fact, according to the SEC, such services were not provided and, as a result, the Fund improperly paid $1.8 million in fees to the Sub-Adviser during the 12-year period from 1996 through 2007. This case follows a September 2010 announcement by the SEC's Division of Enforcement that a "Mutual Fund Fee Initiative" had been established to examine the fees charged by mutual fund advisers; the Initiative is discussed in further detail in the ***October 12, 2010 Investment Management Regulatory Update***.

The SEC alleged that the Adviser willfully violated Section 15(c) of the Investment Company Act of 1940 (the "**Investment Company Act**"), which requires that a majority of the disinterested directors of a registered investment company (a "**RIC**") approve an advisory contract for the RIC and imposes a duty on the investment adviser to provide such information as may reasonably be necessary for the directors to evaluate the terms of any such contract. According to the SEC, at a meeting each year, the Board would evaluate the Fund's advisory contracts—the so-called "15(c) process"—and, based on the information provided by the Adviser, would approve the agreement with the Sub-Adviser. Among the information allegedly provided by the Adviser was an annual report prepared by the Sub-Adviser stating that the Sub-Adviser provided "specific research, intelligence, and advice to" the Adviser, and two compliance reports to the effect that the Sub-Adviser was providing advisory services. In reality, the SEC alleged, the Sub-Adviser's services consisted only of providing two insignificant monthly reports based on readily available public information. According to the SEC, the Adviser was responsible for the Fund's annual and semi-annual reports to shareholders, and these similarly misrepresented the Sub-Adviser's services. The SEC further claimed that the Adviser lacked any "written procedures specifically governing its oversight of sub-advisers, . . . did not have a procedure in place for reviewing work done by [the Sub-Adviser,] . . . did not conduct due diligence visits of [the Sub-Adviser] and performed no other routine supervision of [the Sub-Adviser]."

Based on such conduct, the SEC found that, in addition to violations of Section 15(c), the Adviser willfully violated (1) Section 206(2) of the Investment Advisers Act of 1940 (the "**Advisers Act**"), which prohibits fraudulent conduct by an investment adviser against a client or prospective client; (2) Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder by failing to adopt and implement written procedures reasonably designed to prevent violations of the Advisers Act; and (3) Section 34(b) of the Investment Company Act by filing materially false and misleading annual and semi-annual reports.

According to the SEC's order, without admitting or denying the SEC's findings, the Adviser agreed to pay $1,845,000 to the Fund in reimbursement of the sub-advisory fees, and to implement policies and procedures governing the 15(c) process and the Adviser's oversight of sub-advisers and other service providers, including (i) a requirement that Adviser personnel with direct knowledge of a service provider's services verify the information provided in the 15(c) process, (ii) quarterly certification by unaffiliated sub-advisers (and annual certification by other unaffiliated service providers) that the relevant services had been performed, and (iii) certification regarding and review of unaffiliated sub-advisers by Adviser personnel above a certain level. The SEC also censured the Adviser and ordered it to pay a $1.5 million civil penalty and to cease and desist from further violations of Sections 15(c) and 34(b) of the Investment Company Act, Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-7 thereunder.

- See a copy of the SEC order
- See a copy of the SEC's press release

FINRA Fines Brokerage Firm for Unsuitable Sales of UITs and Floating-Rate Loan Funds

On November 15, 2011, the Financial Industry Regulatory Authority ("**FINRA**") announced the settlement of charges against a registered brokerage firm (the "**Firm**") relating to the Firm's recommendations that customers invest in certain unit investment trusts ("**UITs**")—*i.e.*, investment companies with a finite life that generally hold a fixed portfolio of securities and issue redeemable securities—and floating-rate loan funds ("**FRL Funds**")—*i.e.*, mutual funds that invest in variable rate senior secured loans generally made by financial institutions to companies considered to be below investment grade.

According to FINRA, between January 1, 2007 and December 31, 2008, the Firm sold to 257 customers two UITs that had a significant percentage of their assets invested in closed-end funds consisting, in large part, of high-yield or "junk" bonds, despite the fact that the customers had limited investment experience and conservative risk tolerances. As a result of such recommendations, these customers allegedly lost approximately $1.4 million. During the same period, according to FINRA, the Firm recommended to certain customers seeking preservation of principal and/or with conservative risk tolerances the purchase of FRL Funds that had significant credit and liquidity risk. According to FINRA's findings, these recommendations resulted in losses of more than $736,000. With respect to the sales of UITs, FINRA found that the Firm failed to provide formal training to its brokers and private bankers who sold UITs, lacked adequate policies governing the sales, and did not provide its review desk which was responsible for reviewing and approving such sales with either formal training or guidance on how to evaluate whether UITs were suitable for a given customer. In addition, during the relevant period, a number of UIT transactions allegedly received no principal review or approval. With respect to the sales of FRL Funds, FINRA found that the Firm provided its brokers with no formal training or guidance about the products and permitted investors with low risk tolerances to invest more than 10% of their assets in FRL Funds in contravention of Firm policy.

Based on such conduct, FINRA found that the Firm violated NASD Rule 2110 (now known as FINRA Rule 2010), which requires member firms to conduct their business in a just and equitable manner, and NASD Rule 2310 which requires members to have reasonable grounds for believing that a security recommended for a customer is suitable for such customer. FINRA also found that the Firm violated its obligation under NASD Rule 3010 to maintain a supervisory system reasonably designed to ensure compliance by its associated persons with applicable laws.

In settling the charges, the Firm neither admitted nor denied FINRA's findings. In addition to censuring the Firm, FINRA ordered payment of a $1.7 million fine and restitution of $1.92 million.

- See a copy of the FINRA order
- See a copy of the FINRA press release

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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