Investment Management Regulatory Update

July 24, 2014

SEC Rules and Regulations

SEC Adopts Security-Based Swap Cross-Border Definitional Rule

On June 25, 2014, the SEC adopted the first in a series of rules governing the cross-border reach of its security-based swap regulatory regime. The rules define the term “U.S. person” and provide the test for counting cross-border security-based swap transactions to determine whether a firm must register as a security-based swap dealer or a major security-based swap participant. The final rules also provide a process by which market participants or non-U.S. regulators can request that the SEC make a determination that a foreign regime’s security-based swap rules are comparable to the SEC's, thereby permitting market participants in that jurisdiction to meet SEC rules through compliance with local law. Finally, the rules provide clarification of the SEC’s view of the cross-border application of its anti-fraud authority for all securities. For a detailed discussion of the definitions and process addressed in the Final Rules, please see the July 3, 2014 Davis Polk Client Memorandum, ***SEC Adopts Security-Based Swap Cross-Border Definitional Rule***.

- See a copy of the Final Rules

Industry Update

SEC Staff Responds to Questions Regarding Volcker Rule

On June 10, 2014, the staff of the Divisions of Trading and Markets, Investment Management, and Corporation Finance of the SEC issued responses (the "**Responses**") to frequently asked questions regarding the Volcker Rule. Following the Responses, on June 12, 2014, the Office of the Comptroller of the Currency published interim examination guidelines (the "**Guidelines**") for assessing banking entities' progress toward Volcker Rule compliance during the conformance period. For a detailed discussion of the implications of the Responses and the Guidelines, please see the June 18, 2014 Davis Polk Client Memorandum, ***Volcker Rule: Observations on Interagency FAQs, OCC Interim Examination Guidelines***.

- See a copy of the Responses
- See a copy of the Guidelines

SEC Issues Guidance on Use of Proxy Advisory Firms for Voting Proxies

On June 30, 2014, the SEC staff issued guidance (the "**Guidance**") on proxy advisory firms in the form of Staff Legal Bulletin No. 20 from the Division of Investment Management and the Division of Corporate Finance. The Guidance addresses both the investment advisers' role in proxy voting and their duties and responsibilities if they retain proxy advisory firms to assist in the fulfillment of their voting obligations. The Guidance further describes the exemptions available to proxy advisory firms from the filing and disclosure requirements of the federal proxy rules. For a detailed discussion of the Guidance, please see the July 1, 2014 Davis Polk Client Memorandum, ***SEC Guidance on Use of Proxy Advisory Firms for Voting Proxies***.

- See a copy of the Guidance

SEC Issues Guidance on Verification of Accredited Investor Status Safe Harbor and Definition of Accredited Investor

On July 3, 2014, the Division of Corporate Finance of the SEC issued additional Compliance and Disclosure Interpretations ("**C&DIs**") regarding the non-exclusive verification methods for accredited investor status set forth in Rule 506 of Regulation D under the Securities Act of 1933 ("**Rule 506**") and the net worth and income test for qualifying as an accredited investor set forth in Rule 501 of Regulation D under the Securities Act of 1933 ("**Rule 501**").

Rule 506 is a non-exclusive safe harbor that permits the unregistered sale of securities in private placements to "accredited investors" (including individuals with more than $1 million in net worth, excluding primary residence, or with annual income of more than $200,000 in the prior two years and a reasonable expectation of meeting the threshold in the current year, and companies with more than $5 million in assets), subject to certain conditions. Rule 506(c) permits issuers and their designees to make offers to non-accredited investors, including through widespread advertising and other forms of general solicitation as long as the issuer takes "reasonable steps to verify that purchasers of securities sold in [the offering] are accredited investors." Rule 506(c)(2)(ii) sets forth two non-exclusive verification methods, one on the basis of income and one on the basis of net worth. For a further discussion of the Rule 506, please see the July 29, 2013 Davis Polk Client Memorandum, ***Private Offering Reform: Analysis and Implications.***

The additional C&DIs provided guidance on a number of questions regarding the non-exclusive verification methods and the definition of accredited investor:

Verification on the Basis of Income.

Rule 506(c)(2)(ii)(A) sets forth a non-exclusive method of verifying that a purchaser is an accredited investor by, among other things, reviewing any Internal Revenue Service ("**IRS**") form that reports the purchaser's income for the "two most recent years." The C&DIs clarified that an issuer cannot rely on this verification method if such an IRS form is not yet available for the recently completed year. However, the C&DIs stated that an issuer could use a principles-based verification method to "reasonably conclude that a purchaser is an accredited investor by: "(i) reviewing the IRS forms that report income for the two years preceding the recently completed year and (ii) obtaining written representations from the purchaser that (A) state that an Internal Revenue Service form that reports the purchaser's income for the recently completed year is not available, (B) specify the amount of income the purchaser received for the recently completed year and that such amount reached the level needed to qualify as an accredited investor, and (C) certify that the purchaser has a reasonable expectation of reaching the requisite income level for the current year." The C&DIs cautioned, however, that if the issuer has reason to question the purchaser's claim to be an accredited investor after reviewing these documents, it must take additional verification measures to comply with Rule 506.

The C&DIs also stated that an issuer may not review comparable tax forms from a foreign jurisdiction from a purchaser who is not a U.S. taxpayer to rely on the verification method provided in Rule 506(c)(2)(ii)(A). However, it further explained that an issuer could still reasonably conclude that such non-U.S. purchaser is an accredited investor under the principles-based verification method by reviewing filed tax forms that report income where the foreign jurisdiction "imposes comparable penalties for falsely reported information."

Verification on the Basis of Net Worth.

Rule 506(c)(2)(ii)(B) allows an issuer to verify that a purchaser is an accredited investor on the basis of net worth by reviewing certain documentation (including tax assessments) of the purchaser's assets and liabilities "dated within the prior three months." The C&DIs clarified that an issuer will not be able to rely on this non-exclusive verification method upon review of a tax assessment dated more than three months prior to such review, even if such tax assessment is only prepared annually. The C&DIs further stated that an issuer could still reasonably conclude that a purchaser is an accredited investor under the principles-based verification method by using the most recently available tax assessment. The C&DIs stated, by way of example, that if the most recent tax assessment shows a value in excess of $1 million (after deducting the purchaser's liabilities), it "may be sufficient verification that the purchaser has met the net worth test."

Another form of documentation set forth in Rule 506(c)(2)(ii)(B), with respect to assessing a purchaser's liabilities, is a "consumer report from at least one of the nationwide consumer reporting agencies." The C&DIs clarified that a consumer report from a non-U.S. consumer reporting agency that performs similar functions as a U.S. nationwide consumer reporting agency would not be sufficient for purposes of the verification safe harbor. However, according to the C&DIs, an issuer could reasonably conclude that a purchaser providing such report is an accredited investor by reviewing the report and "taking any other steps necessary to determine the purchaser's liabilities (such as a written representation from the purchaser that all liabilities have been disclosed) in determining whether the purchaser has the requisite net worth."

Accredited Investor Status.

Rule 501(a)(6) provides that a natural person who had an individual income in excess of $200,000 in each of the two most recent years, or joint income with that person's spouse in excess of $300,000 in each of those years, and has a reasonable expectation of reaching the same income level in the current

year, in both cases at the time such person is sold securities, is an accredited investor. The C&DIs clarified that, in the case of a purchaser whose annual income is not reported in U.S. dollars, an issuer may use either the exchange rate that is in effect on the last day of the year for which income is being determined or the average exchange rate for that year in determining whether such income meets the income test for qualifying as an accredited investor.

Rule 501(a)(5) provides that a natural person whose individual net worth, or joint net worth with that person's spouse, exceeds $1,000,000, at the time such person is sold securities, is an accredited investor. The C&DIs stated that assets in an account or property owned jointly with a person who is not the purchaser's spouse may be included in the calculation for the net worth test, but "only to the extent of his or her percentage of the account or property."

- See a copy of the C&DIs

IM Guidance Update Advises Mutual Funds on Enhanced Disclosure Requirements

In June 2014, the Division of Investment Management of the SEC issued an IM Guidance Update to provide additional guidance to mutual funds with respect to their enhanced disclosure requirements under Rule 498 and Form N-1A.

In 2009, the SEC amended Form N-1A—the registration form used by mutual funds—and Rule 498 under the Securities Act of 1933 to provide investors with more straightforward and accessible information when making investment decisions. Please see the ***February 9, 2009 Investment Management Regulatory Update*** for a discussion of the 2009 amendments. The IM Guidance Update summarized these amendments, highlighting the requirement that the Form N-1A include a brief summary prospectus at the front of a mutual fund's prospectus describing the fund's investment strategy and risks clearly and concisely (the "**Summary Section**"). Additionally, the IM Guidance Update briefly discussed the previous amendments to Rule 498 under the Securities Act, which allow mutual funds to send investors a copy of the key information included in the Summary Section (a "**Summary Prospectus**"), and make the statutory prospectus available through an internet website, so long as copies of the statutory prospectus are delivered to investors via paper or email upon request.

The IM Guidance Update stated that the Staff has observed that, while many funds provide clear and concise Summary Sections, some Summary Sections remain complex, overly technical and inaccessible. Although the SEC Staff declined to impose page limits on Summary Sections, according to the IM Guidance Update, the Staff intends that mutual funds prepare a *concise* summary on the order of "three to four pages." The Staff further highlighted the following disclosure requirements:

- **Summarize the Principal Investment Strategies and Risks**: The Staff explained that Item 4 in the Summary Section of Form N-1A, which requires a statement of the fund's principal investment strategies and risks, is not meant to merely duplicate information found in response to Item 9 of Form N-1A, but is meant to be a concise summary of such information.
- **Plain English Requirement**s: The Staff highlighted the requirement of Form N-1A that the Summary Section be provided in plain English under Rule 421(d) under the Securities Act, and the principal that prospectus disclosure requirements are intended to "elicit information for an average or typical investor who may not be sophisticated in legal or financial matters." According to the Staff, funds often use technical terms, unnecessary defined terms, and long sentences and paragraphs that may be difficult for investors to comprehend. The Staff reiterated that the Summary Section should be drafted in plain English and all information should be presented in a clear, concise, and accessible way.
- **Summary Section Must Only Include Required or Permitted Information**: The Staff stated that the Summary Section may only include information required or permitted by Items 2 through 8 of Form N-1A. According to the Staff, the Staff often comments on whether information in the

footnotes to the Fee Table is permitted or required and whether the inclusion of purchase and sale information goes beyond what is required or permitted by Item 6.

- **Inclusion of Non-Principal Strategies and Risks in the Prospectus**: The Staff further focused on the requirement to provide information about a fund's principal investment strategies and risks, noting that Form N-1A also permits a fund to disclose any investment strategies or risks that are not principal. However, according to the Staff, funds that include such additional information about non-principal risks and strategies often do not clearly indicate which of the strategies and risks are principal and which are not.
- **Avoid Cross-References**: The Staff stated that funds should avoid making cross-references to the Statement of Additional Information or shareholder reports in the prospectus, particularly in the Summary Section.

The Staff concluded by encouraging mutual funds to revisit their disclosure.

- See a copy of the IM Guidance Update

IM Guidance Update Advises Series Investment Companies on Affiliated Transactions

In June 2014, the Division of Investment Management of the SEC issued an IM Guidance Update reminding mutual funds operating as series companies that the prohibitions on certain affiliated transactions under the Investment Company Act apply to each series.

According to the IM Guidance Update, a typical mutual fund operates as a "series company: "a single trust established under one set of organizational documents (with a board of directors or trustees) that offers investors multiple investment portfolios (series). According to the IM Guidance Update, each series is treated as a separate investment company "for purposes of the investor protections afforded by" the Investment Company Act.

The IM Guidance Update stated that some of the principal provisions of the Investment Company Act apply to mutual funds and their "affiliated persons," and advised mutual funds operating as series companies of the importance of ensuring that their compliance policies and procedures are "reasonably designed" to prevent violations of the federal securities laws as they apply to each series, and in particular to review their compliance policies and procedures for identification of "affiliated persons" with respect to each series of the mutual fund. By way of example, the IM Guidance Update stated that Section 17(a) of the Investment Company Act generally prohibits an affiliated person of a mutual fund (or an affiliated person of such person) from selling any property, including any security, to the mutual fund, and that the series is the relevant person for purposes of determining whether the counterparty to a mutual fund's transaction is an affiliated person. Therefore, according to the Staff, since an affiliated person of a mutual fund includes, among other things, a person who owns 5% or more of the outstanding securities of such mutual fund, a mutual fund's compliance policies and procedures should cover the identification of persons owning 5% or more of the outstanding voting securities (among other things) *of a series*, as appropriate for the circumstances of the particular mutual fund.

- See a copy of the IM Guidance Update

IM Guidance Update Clarifies Asset Coverage Requirements for Business Development Companies with Wholly-Owned SBIC Subsidiaries

In June 2014, the Division of Investment Management of the SEC issued an IM Guidance Update with respect to exemptive orders granting limited relief to business development companies ("**BDCs**") with wholly owned small business investment company ("**SBIC**") subsidiaries from the asset coverage requirements of Sections 18(a) and 61(a) of the Investment Company Act.

An SBIC is a company that has received a license from the Small Business Administration (the "**SBA**") to operate as such under the Small Business Investment Act of 1958 (the "**SBIA**"). Section 18(a)(1) of the Investment Company Act generally imposes certain asset coverage requirements on registered closed-end companies that restrict their ability to issue any class of senior security representing debt, and, subject to certain modifications, Section 61(a) of the Investment Company Act generally extends those requirements to BDCs. According to the IM Guidance Update, since a BDC may be an indirect issuer of any class of senior security issued by its wholly-owned SBIC subsidiary, the BDC would also be required to comply with the asset coverage requirements on a consolidated basis. However, the IM Guidance Update noted that the SEC has granted exemptive relief to a number of BDCs, permitting such BDCs (subject to representations and conditions set forth in the exemptive applications) to treat certain indebtedness issued by their wholly-owned SBIC subsidiaries as "indebtedness not represented by senior securities" for purposes of evaluating whether the BDCs have complied with the asset coverage requirements imposed by Section 18(a)(1) (through Section 61(a)) of the Investment Company Act.

The IM Guidance Update further described certain representations included in such exemptive order applications, including the representation that companies operating under the SBIA (including the applicants' SBIC subsidiaries) are subject to the SBA's "separate regulation of permissible leverage in their capital structure." Although, according to the IM Guidance Update, the representations and condition of requested relief have not explicitly required that the SBIC subsidiary have issued indebtedness guaranteed by the SBA, the Staff stated that it believes such requirement is "implicit in the rationale for the relief." Therefore, the IM Guidance Update stated that where an SBIC subsidiary has not issued indebtedness such that it is held or guaranteed by the SBA, the Staff does not believe that a BDC could rely on its existing order in a manner consistent with the representations made in its request for exemptive relief. As such, the IM Guidance Update requested that all new applications for relief from the asset coverage requirements for BDCs with wholly-owned SBICs include a modified condition that "any senior securities representing indebtedness of an SBIC subsidiary will not be considered senior securities and, for purposes of the definition of 'asset coverage' in Section 18(h) [of the Investment Company Act], will be treated as indebtedness not represented by senior securities but only if that SBIC subsidiary has issued indebtedness that is held or guaranteed by the SBA."

- See a copy of the IM Guidance Update

IM Guidance Update Clarifies Application of the Custody Rule to Special Purpose Vehicles and Escrow Accounts

In June 2014, the Division of Investment Management of the SEC (the "**Division**") issued an IM Guidance Update regarding the application of Rule 206(4)-2 under the Advisers Act (the "**Custody Rule**") when investment advisers to pooled investment vehicles use (i) special purpose vehicles when making investments ("**Investment SPVs**") and (ii) escrow accounts when selling interests in portfolio companies.

Investment Special Purpose Vehicles

According to the IM Guidance Update, the SEC stated in the Custody Rule adopting release (the "**Custody Rule Release**") that to comply with the "Delivery to Related Person" section of the Custody Rule (Rule 206(4)-2(c)), an investment adviser may either treat an Investment SPV as a separate client (in which case the adviser would have custody of the Investment SPV's assets) or treat the Investment SPV's assets as assets of the pooled investment vehicle of which it has custody indirectly. The audit exception to certain custody rule requirements (as set forth in Rule 206(4)-2(b)(4) under the Advisers Act (the "**audit provision**")) generally requires, among other things, the pooled investment vehicle to be subject to audit at least annually by an independent public accountant registered with the Public Company Accounting Oversight Board and for the audited financial statements to be sent to all beneficial owners of the pool within 120 days after such audit. If the adviser is relying on the audit provision and treats the Investment SPV as a separate client, according to the SEC, the Custody Rule requires the

adviser to comply separately with the Custody Rule's "audited financial statement distribution requirements." If, however, the adviser is treating the Investment SPV's assets as assets of the pooled investment vehicle of which it has custody indirectly, according to the SEC, the assets of the Investment SPV fall within the scope of the pooled investment vehicle's financial statement audit.

For advisers falling into the latter category, the Staff provided the guidance for the followings illustrative scenarios:

- **Single purpose vehicles; multi-fund single purpose vehicles; and multi-purpose vehicles**: According to the IM Guidance Update, advisers have asked whether an adviser relying on the audit provision may choose to treat the assets of a various types of special purpose investment vehicles as assets of the pooled investment vehicle client. These types of special purpose vehicles include single purpose vehicles (i.e., vehicles utilized by an adviser to purchase a single investment on behalf of a pooled investment vehicle), multi-fund single purpose vehicles (i.e., vehicles utilized by an adviser to purchase an investment on behalf of multiple pooled investment vehicles) and multi-purpose vehicles (i.e., vehicles utilized by an adviser to purchase multiple investments on behalf of one or more pooled investment vehicles). The Staff responded that the adviser may treat the special purpose vehicle's assets as assets of the pooled investment vehicle client if (1) the assets of the special purpose vehicle fall within the scope of the pooled investment vehicle's financial statement audit and (2) the special purpose vehicle is solely owned by the adviser, the adviser's related persons or the pooled investment vehicle(s) controlled by the adviser or the adviser's related persons.
- **Investment fund**: The Staff explained that advisers have asked whether an adviser relying on the audit provision may treat the assets of an investment fund (i.e., a vehicle utilized by an adviser to purchase one or more investments on behalf of one or more pooled investment vehicles and third parties that are not pooled investment vehicles controlled by the adviser or the adviser's related persons) as assets of the pooled investment vehicle client or clients. The Staff responded that the Division generally believes an adviser relying on the audit provision should treat the assets of the investment fund as a separate client for purposes of the Custody Rule, and therefore the adviser should generally comply separately with the custody rule's audited financial statement distribution requirements with respect to the investment fund.

Escrow Accounts

The IM Guidance Update stated that the Division receives inquiries from advisers with respect to the application of the Custody Rule to escrow accounts that are generally used for a finite period of time in connection with the sale of a portfolio company owned by one or more pooled investment vehicle clients of such advisers ("**Escrows**"). The Staff explained that the bulk of such inquiries focus on circumstances where a portfolio company is sold by one or more pooled investment vehicles and, as part of the sale or merger, the sellers (including the pooled investment vehicle clients) often appoint a representative to act on their behalf with respect to a portion of the sale proceeds held in Escrow following the closing of the transaction.

According to the IM Guidance Update, the Custody Rule generally requires a registered investment adviser to maintain funds and securities over which it has custody "with a qualified custodian in a separate account for each client in the client's name, or in accounts that contain only the adviser's clients' funds and securities that are maintained in the adviser's name as agent or trustee for the clients." In many cases, according to the IM Guidance Update, funds held in Escrows belong to both the client and other sellers that are not the adviser's clients. In such a situation, according to the Staff, advisers have told the Staff that joint Escrows provide adequate protection to clients.

The Staff stated that advisers may maintain client funds in an Escrow containing both client and non-client assets so long as: (1) the client is a pooled investment vehicle relying on the audit provision and includes in its financial statements the portion of the Escrow attributable to such pooled investment

vehicle; (2) the Escrow is related to the merger or sale of a portfolio company owned by the client; (3) the Escrow contains an amount of money that is agreed upon as part of negotiations between the buyer and the seller; (4) the Escrow exists for an agreed-upon limited amount of time; (5) a qualified custodian maintains the Escrow; and (6) the sellers' representative is contractually bound to distribute the funds remaining in the Escrow to the sellers (including the pooled investment vehicle clients) at the conclusion of the escrow period on a predetermined formula.

- See a copy of the IM Guidance Update
- Read the Custody Rule Release

Litigation

SEC Brings the First Case for Violation of the Pay-to-Play Rule and Integration of Two Exempt Reporting Advisers for Determining Advisers Act Registration Status

On June 20, 2014, the SEC charged TL Ventures Inc. ("**TL Ventures**"), a Philadelphia-based private equity firm, with violating Section 206(4) of the Advisers Act and Rule 206(4)-5 thereunder (commonly known as "**pay-to-play rule**") by receiving advisory fees from two government pension funds after its associate made certain political contributions. Notably, according to the press release, this marks the SEC's first case under the pay-to-play rules for investment advisers. Separately, the SEC charged TL Ventures and Penn Mezzanine Partners Management L.P. ("**Penn Mezzanine**"), a registered investment adviser affiliated with TL Ventures, with improperly claiming exemptions from SEC registration in violation of Sections 203(a) and 208(d) of the Advisers Act.

The pay-to-play rule generally prohibits investment advisers from providing advisory services for compensation to a government client for two years after the adviser or any of its "covered associates" (including certain officers and employees of the adviser) makes a campaign contribution to certain elected officials or candidates. Please see the ***July 14, 2010 Investment Management Regulatory Update*** and the ***April 15, 2011 Investment Management Regulatory Update*** for more information about the pay-to-play rule.

According to the SEC's order, a covered associate of TL Ventures made a $2,500 contribution to a candidate for Mayor of Philadelphia and a $2,000 contribution to the Governor of Pennsylvania, both in 2011. The SEC stated that the City of Philadelphia Board of Pensions and Retirement (the "**Philadelphia Board**") and the Pennsylvania State Employees' Retirement System ("**PSERS**") were both investors in funds advised by TL Ventures. The SEC stated that the Mayor of Philadelphia and the Governor of Pennsylvania are authorized to appoint board members to the Philadelphia Board and PSERS, respectively, and that they are therefore "in a position to influence the selection of investments by those pension funds." Therefore, according to the SEC, since during the two years after the covered associate's contributions, TL Ventures continued to provide compensatory advisory services to these two government pension funds and receive advisory fees from such pension funds, TL Ventures violated Section 206(4) of the Advisers Act and Rule 206(4)-5 thereunder.

Section 203(a) of the Advisers Act generally prohibits an investment adviser from acting as such unless it is registered with the SEC or exempt from registration, and Section 208(d) of the Advisers Act generally makes it unlawful for a person indirectly to do anything which would be unlawful for such person to do directly under the Advisers Act.

According to the SEC's orders, TL Ventures claimed to solely advise venture capital funds and thus be exempt from registration under Section 203(l) of the Advisers Act and Penn Mezzanine claimed to solely advise private funds and have assets under management in the United States of less than $150 million, and thus to be exempt from registration under Rule 203(m)-1 under the Advisers Act. However, the SEC alleged that since the facts and circumstances surrounding the relationship between TL Ventures and

Penn Mezzanine indicated they were under common control and should have been treated as a single investment adviser for purposes of the registration requirements, the SEC claimed that once integrated, they would not qualify for any exemption from registration.

In the orders, the SEC determined that TL Ventures and Penn Mezzanine were operationally integrated on the basis of the following alleged facts: (1) TL Ventures and Penn Mezzanine disclosed in their exempt reporting adviser reports filed with the SEC that they were under common control; (2) certain employees and associated persons of TL Ventures had substantial ownership interests in Penn Mezzanine; (3) TL Ventures and Penn Mezzanine shared several employees and associated persons, including those who provided investment advice and (4) TL Ventures and Penn Mezzanine had "significantly overlapping operations" (including in marketing and communication, solicitation of investors and investment committee activity) and failed to maintain policies and procedures that would keep the entities separate. Accordingly, the SEC charged TL Ventures and Penn Mezzanine with willful violations of Sections 203(a) and 208(d) of the Advisers Act for acting through or by Penn Mezzanine and TL Ventures, respectively, to engage in the business of providing investment advice without registering as an investment adviser.

Without admitting or denying the SEC's findings, TL Ventures agreed to be censured and to cease and desist from committing or causing further violations of Sections 203(a), 206(4) (including Rule 206(4)-5 thereunder) and 208(d) of the Advisers Act. In addition, TL Ventures agreed to pay disgorgement of $256,697, prejudgment interest of $3,197 and a penalty of $35,000. Without admitting or denying the SEC's findings, Penn Mezzanine agreed to be censured and to cease and desist from committing or causing further violations of Sections 203(a) and 208(d) of the Advisers Act.

- See a copy of the SEC Order against TL Ventures
- See a copy of the SEC Order against Penn Mezzanine
- See a copy of the Press Release

SEC Charges Hedge Fund Adviser with Conducting Conflicted Transactions and Retaliating Against Whistleblower

On June 26, 2014, the SEC issued an order instituting cease-and-desist proceedings (the "**Order**") against Paradigm Capital Management ("**Paradigm**"), an Albany, N.Y.-based hedge fund advisory firm, and its owner for engaging in prohibited principal transactions and subsequently retaliating against the employee who reported the trading activity to the SEC, in violation of Section 21F(h) of the Securities Exchange Act of 1934 and Sections 206(3) and 207 of the Advisers Act. According to the press release, this case marks the first time that the SEC has used its new authority under the Dodd-Frank Wall Street Reform and Consumer Protection Act to bring anti-retaliation enforcement actions.

Section 206(3) of the Advisers Act generally prohibits an investment adviser from executing principal transactions without client consent. According to the SEC's order, Paradigm's owner conducted transactions between Paradigm and a broker-dealer also owned by the owner on behalf of a hedge fund client (the "**Fund**"). Paradigm did not, according to the SEC, disclose these principal transactions to the Fund or obtain the Fund's consent.

Section 207 of the Advisers Act generally prohibits advisers from making material misstatements or omissions in SEC reports or registration applications. According to the SEC, Paradigm violated Section 207 of the Advisers Act by stating in its Form ADV Part 2A that the Conflicts Committee acts on behalf of the Fund when approving principal transactions, and failing to disclose that a member of the Conflicts Committee of the Fund was also a CFO of the affiliated broker-dealer with whom Paradigm was engaging in trades on the Fund's behalf.

In addition, according to the Order, a whistleblower—then the head trader of Paradigm—reported this trading activity to the SEC, and upon learning of this fact, Paradigm undertook retaliatory actions against

the whistleblower (including by changing his job function to a full-time compliance assistant and stripping him of supervisory responsibilities), ultimately resulting in his resignation.

Without admitting or denying the SEC's findings, Paradigm and its owner settled the proceedings. Paradigm agreed to cease and desist from committing or causing further violations of the federal securities laws. In addition, Paradigm agreed to hire an independent compliance consultant to review its policies. Paradigm and its owner also agreed to jointly and severally pay disgorgement of $1.7 million for distribution to current and former investors in the Fund, and to pay prejudgment interest of $181,771 and a penalty of $300,000.

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

NYC Pension Funds Enact Placement Agent Ban

The New York City Comptroller announced that the five New York City pension funds have passed a resolution to ban the use of placement agents across all investment classes. The pension funds previously banned the use of placement agents for private equity investments only. According to the Comptroller, this decision was made to "ensure that the integrity and independence of our investment decisions are beyond reproach and without conflict."

Many private fund managers engage third-party middlemen, known as placement agents, to introduce investors to their funds as an alternative to using their own staff. According to the press release, the ban on placement agents is effective immediately for all prospective investments made by any of the five pension funds.

- See a copy of the Press Release

Notes from Europe: European Regulatory Developments

Reminder: End of Alternative Investment Fund Managers Directive Transition Period

On July 21, 2014, the one year transitional period under the Alternative Investment Fund Managers Directive ("**AIFMD**") will come to an end. As a consequence, from July 22, 2014, non-EU alternative investment managers ("**AIFMs**") seeking to market non-EU alternative investment funds ("**AIFs**") to investors in EU Member States will be obliged to either notify or seek the prior approval of the competent authority of the relevant EU Member State (depending on the EU Member State in question), irrespective of whether the AIFM in question was marketing an AIF in that Member State prior to July 22, 2013. Non-EU AIFMs may, depending on the Member State in question, continue to gauge interest in their space via passive marketing. They may also be able to rely on reverse inquiry in certain circumstances. In light of the different legal and regulatory interpretations of passive marketing and reverse inquiry across the Member States, however, the advice of local counsel in the relevant Member State should be sought before commencing any passive marketing activities or responding to inquiries from prospective investors. It should further be noted that third parties marketing non-EU AIFs on behalf of non-EU AIFMs, such as placement agents, may only market in Member States where the non-EU AIFM may itself market the AIF.

For further information on the notification or registration requirements in Member States or for passive marketing or reverse inquiry enquiries, please do not hesitate to contact your usual Davis Polk Investment Management contact or **Richard Small** in Davis Polk's London office.

UK: Alternative Investment Funds in the Form of Limited Partnerships

On June 26, 2014, the UK Financial Conduct Authority ("**FCA**") issued a statement on its website in response to queries as to how to determine where an AIF in the form of a limited partnership is established. The FCA was responding to specific queries, including with respect to:

- a Guernsey limited partnership with a Guernsey registered office but a principal place of business in the UK; and
- a UK limited partnership with a principal place of business in Guernsey.

The AIFMD defines "established" in Article 4(1)(j)(ii) as, for AIFs, "being authorised or registered in", or, if the AIF is not authorized or registered, "having its registered office in." The FCA has clarified that for an AIF that is not authorized or registered anywhere in the European Economic Area ("**EEA**") and that has a registered office, the FCA considers the AIF's place of establishment to be the country or territory where that office is located. The FCA pointed out that an AIF is not authorized or registered unless it is authorized or registered as a fund (the FCA further pointed out that registration at Companies House does not satisfy this requirement). In view of this, in the case of a Guernsey limited partnership that has its registered office in Guernsey, the FCA is of the view that this would be a non-EEA AIF even though its principal place of business is in the UK. The FCA further noted that UK limited partnerships do not have registered offices, although they are required to register their principal place of business and as such the FCA would regard such registered principal place of business as being the equivalent of a registered office for these purposes. On that basis, a UK limited partnership with a principal place of business in Guernsey would be considered by the FCA to be a non-EEA AIF. To the extent that there is no registered office, the location of the head office of the AIF would be relevant in determining its place of establishment.

- See a copy of the UK AIFM Regulation 2013 (SI 2013/1773)

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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